89-1105

No.

In The
Supreme Court of the United States

October Term, 1989

John C. and Gayle A. Zinniel,
David N. and Jane A. Merryfield,
James G. and Margaret Samuels,
Petitioners
v.

Commissioner of Internal Revenue Service

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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QUESTIONS PRESENTED

1. Whether cost determinations made by the United States Tax Court under Section 7430 of the Internal Revenue Code are subject to *de novo* appellate review?

2. Whether in making a determination under Section 7430 of the Internal Revenue Code, a court is limited to considering the government's in-court litigating position?

3. Whether it is unreasonable under Section 7430 of the Internal Revenue Code for the Commissioner of the Internal Revenue to take a litigation position on the application of a new statute, where such application is contrary to case law, and where the Commissioner is under a Congressional mandate to promulgate regulations to clarify the law and fails to do so?

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OPINIONS BELOW

The opinion of the Court of Appeals is reported at 883 F.2d 1350. (App. 1a-26a) The Memorandum Sur Order of the Tax Court denying litigation costs is unreported. (App. 31a-36a) The opinion of the Tax Court on the underlying litigation is reported at 89 TC 357. (App. 38a-56a).

JURISDICTION

The judgment of the Court of Appeals was entered on September 6, 1989. (App. 27a). A petition for rehearing and suggestion for rehearing en banc was filed on September 20, 1989. (App. 30a). The petition for rehearing and suggestion for rehearing en banc was denied on October 18, 1989. (App. 30a). The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTORY PROVISION INVOLVED

Section 7430 of the Internal Revenue Code of 1954 (26 U.S.C.), as applicable to cases commenced prior to December 31, 1985, is set forth in pertinent part below.

26 U.S.C. § 7430 (1954)

(a) In general. In the case of any civil proceeding which is—

(1) brought by or against the United States in connection with the determination, collection, or refund of any tax, interest, or penalty under this title, and

(2) brought in a court of the United States (including the Tax Court and the United States Claims Court), the prevailing party may be awarded a judgment for reasonable litigation costs incurred in such proceeding.

* * * *

(c) Definitions—For purposes of this section.

* * * *

(2) Prevailing party.

(A) In general. The term "prevailing party" means any party to any proceeding described in subsection (a) (other than the United States or any creditor of the taxpayer involved) which

(i) establishes that the position of the United States in the civil proceeding was unreasonable, and

(ii) (I) has substantially prevailed with respect to the amount in controversy, or

(II) has substantially prevailed with respect to the most significant issue or set of issues presented.

STATEMENT

This case involves the application of Section 7430 of the Internal Revenue Code,[1] which requires the United States to pay a prevailing taxpayer's "reasonable litigation costs" if a court finds that the government's position in a tax case was "unreasonable."[2] (App. 9a). The underlying action from which John C. and Gayle Zinniel, David N. and Jane A. Merryfield, James G. and Margaret Samuels (Taxpayers) seek litigation costs relates to whether a corporation's subchapter S election had been properly terminated under section 1372(e)(1) of the Code. (App. 2a). The Commissioner of Internal Revenue (Commissioner) contended that in order to properly terminate an election, section 1372(e)(1) as amended, required new shareholders to file a document with the Internal Revenue Service indicating that the shareholders refused to consent to the election. (App. 3a). Conversely, the Taxpayers established that section 1372(c)(1) only required the refusal to consent document to be filed with the corporation (App. 3a).

Section 1372(e)(1)(A) of the Code, the controlling Code section in the underlying case, was amended on October 4, 1976, effective for tax years beginning after December 31, 1976, to require new shareholders to affirmatively refuse to consent to a subchapter S election in

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[1] Unless otherwise noted, all section and Code references are to the Internal Revenue Code, as amended and in effect during the tax years in issue. Unless otherwise noted, all Rule references are to the United States Tax Court Rules of Practice and Procedure.

[2] For cases commencing after December 31, 1985, "reasonable litigation costs" are available if a prevailing taxpayer can demonstrate that the government's position was "not substantially justified." Tax Reform Act of 1986, Pub. L. No. 99-514, § 1551(h), 100 Stat. 2085, 2753. The courts which have compared the "unreasonable" and "not substantially justified" standards have concluded there is "no dispositive difference between the two standards." *Kaufman v. Egger*, 584 F. Supp. 872, 877 n.1 (D. Me. 1984), *aff'd*, 758 F.2d 1 (1st Cir. 1985).

order to terminate such election. Tax Reform Act of 1976, P.L. 94-445, § 902(c)(3). 90 Stat. 1520, 1609 (1976) (App. 4a). This amendment directed the Commissioner to promulgate regulations setting forth the manner in which affirmative refusals were to be made. At all times relevant to this controversy, the Commissioner was under a Congressional mandate to promulgate final or temporary regulations under section 1372(e)(1)(A), and failed to do so. (App. 21-22a).

The subchapter S election at issue related to Sierra Limited, a Wisconsin corporation, which at its inception in 1976 had three shareholders, John G. Zinniel, David N. Merryfield, and James G. Samuels. (App. 3a). In 1977 the shareholders decided to terminate the subchapter S status of Sierra Limited. On November 30, 1977, the three shareholders each transferred shares of stock to their wives in order to effectuate the termination (App. 6a). Simultaneously with the stock transfer, the wives executed an affirmative refusal to consent to the subchapter S election and delivered same to the corporation (App. 6a). At the same time, Sierra Limited filed with the Commissioner a Form 5301, Application For Determination for Defined Contribution Plan. The Form 5301 clearly reflected that Sierra was a "Corporation" for tax purposes and not a subchapter S corporation (App. 6a). On February 23, 1978, the Commissioner issued to Sierra Limited a favorable determination letter with respect to its defined contribution plan. (App. 20a). This determination could not have been made if Sierra Limited was a subchapter S corporation. In June of 1978, the Corporation filed its income tax return with the Commissioner and reported the termination of the corporation's status as a subchapter S corporation. (App. 20a).

In conjunction with the November, 1977 stock transfer, the Taxpayer's attorney sought advice by phone and by letter from the Milwaukee District Director's office with respect to the new method for termination of a sub-

chapter S corporation. (App. 22a). The taxpayer's attorney was advised by the District Director's office that there was no information available and that regulations had not been promulgated despite a Congressional mandate to so do. (App. 22a).

At all times relevant to this controversy, there were no regulations, letter rulings or revenue procedures regarding the new method for termination of a subchapter S election. (App. 7a). On April 17, 1980, the Commissioner published *proposed* regulations, which did not have the force of law, regarding the "affirmative refusal." (App. 10a). These proposed regulations included curative provisions found in Proposed Treas. Reg. § 1.1372-3(b)(3) (1980). (App. 7a). The Commissioner took the position that the curative provision provided no relief to the Taxpayers because the phrase—"that was not properly filed" found in subparagraph (3) of the proposed regulation included only defective affirmative refusals that were filed incorrectly with the Commissioner. (App. 52-56a).

On June 6, 1984, the Commissioner issued a notice of deficiency to the Taxpayers for years 1978 and 1979, from which petitions were filed in the United States Tax Court. (App. 7a). The Commissioner took the position that in order to terminate the subchapter S status the new shareholders of the corporation must file an affirmative refusal to consent with the Commissioner. (App. 8a). The Taxpayers prevailed with respect to the entire amount in controversy and all of the issues presented. (App. 56a). In rejecting the Commissioner's position, the Tax Court chided the Commissioner for its failure to issue regulations under section 1372(e)(1), in direct contravention of a Congressional mandate. (App. 55a).

Having prevailed on the merits, the Taxpayers filed a motion requesting that the Commissioner pay reasonable litigation costs incurred by the Taxpayers pursuant to section 7430. (App. 31a). In denying the Taxpayer's

motion in an unpublished Memorandum Sur Order, Judge Wells of the Tax Court held that the Commissioner's position was not unreasonable because the case was a complex case of first impression.[3] (App. 35a).

On appeal to the Seventh Circuit, the Panel majority affirmed the Tax Court's denial of litigation costs. (App. 27-28a). Judge Will, a Senior United States District Judge, sitting by designation, strongly dissented. (App. 19-26a). As a threshold matter, the majority concluded that the standard of review of cost determinations under section 7430 is abuse of discretion. (App. 9-11). In examining the unreasonableness of the Commissioner's position the majority ruled that the Taxpayers had not sufficiently "place[d] in issue the administrative posture of the Commissioner." (App. 13a). As such, the administrative history of the case, which the majority viewed as a "new argument", was not reviewable. (App. 13a). The Panel majority went on to adopt the Tax Court's reasoning and substantiated the denial of costs on the basis of references to a "filing" contained within the General Explanation of the Tax Reform Act of 1976, commonly referred to as the Blue Book. (App. 18a).

REASONS FOR GRANTING THE PETITION

This case preesnts the Court with an opportunity to resolve a split between the circuits on the issues of the proper of standard of review of determinations under section 7430, and the proper standard of review of mixed questions of law and fact generally. Further, this case provides the Court with the occasion to eliminate the conflict between the circuits on what constitutes a "position of the United States" for purposes of section 7430.

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[3] Judge Wells' order incorrectly states that the Commissioner asserted that the taxpayers did not exhaust their administrative remedies. (App. 33a). The Commissioner has acknowledged that this is not so. (Appellee's BR at 13).

A grant of certiorari is also necessary for the fair administration of the tax laws. In disregarding the purposes of section 7430, the majority opinion of the Seventh Circuit Panel grants free license to the Commissioner to ignore a mandate of Congress to provide necessary taxpayer guidance. The majority's decision flatly contradicts the well settled principle that if the uncertainty in the law was a result of the Commission's own inaction, it must be held against the Commissioner. In view of the Commissioner's current administrative stance with respect to the issuance of Congressionally mandated regulations, the Commissioner's egregious conduct in this case is capable of repetition. Accordingly, this case is not unique and the interests of all taxpayers are implicated.

I. THE CONFLICT OVER THE STANDARD OF REVIEW

The Panel majority concluded that the standard of review of cost determinations under section 7430 is abuse of discretion. (App. 10a). In adopting the abuse of discretion standard, the majority correctly pointed out that there is a split between the circuits as to the proper standard of review of determinations under section 7430. (App. 9a). The Ninth Circuit has concluded that a determination of the unreasonableness of Commissioner under section 7430 presents a mixed question of law and fact, and is subject to *de novo* review. *United States v. Harvis Constr. Co.*, 857 F.2d 1360, 1362 (9th Cir. 1988); *Sliwa v. Commissioner*, 839 F.2d 602, 604 (9th Cir. 1988). In contrast, the Eighth Circuit, without explanation, embraced the absue of the discretion standard. *Berks v. United States*, 825 F.2d 1263 (8th Cir. 1987).

In view of the stipulated record and undisputed rule of law here, this case also affords the Court with an opportunity to resolve the long-standing conflict existing as to the proper standard of review of mixed questions of law and fact generally. Under this Court's holding in

Pullman-Standard v. Swint, 456 U.S. 273, 298 n.19 (1982), it is established that a mixed question of law and fact exists where "facts are admitted or established, the rule of law is undisputed, and the issue is whether the facts satisfy the statutory standard . . . ." In *Pullman-Standard* the Court pointed out that the circuits are split on the proper standard of review of mixed questions of law and fact. *Id.* In the instant case, the Commissioner and the taxpayers fully stipulated to the facts, and the rule of law was undisputed. (App. 39a). In fact, the United States Tax Court Rules of Practice and Procedure make the stipulation of uncontested facts mandatory. Tax Ct. A. Prac. 91(a). Therefore, the review of a cost determination under section 7430 from the Tax Court, in the absence of contested facts, constitutes a mixed question of law and fact.

The majority Panel in the instant case embraced the abuse of discretion standard based solely upon the holding in *Pierce v. Underwood.* 108 S. Ct. 2541 (1988). (App. 10a). In *Pierce* the Court held that the proper standard of review of cost determinations under the Equal Access to Justice Act (EAJA)[4] was abuse of discretion. *Id.* at 2547. The relevant section of the EAJA provides that attorney fees shall be awarded "unless *the court finds* that the position of the United States was substantially justified." 28 U.S.C. § 2412(d)(1)(A) (emphasis added). The *Pierce* Court held that the above EAJA formulation suggests that under the EAJA some deference is owed to the district court upon appeal. *Pierce,* 108 S.Ct. at 2547. The Court concluded that the formulation of the EAJA, "as opposed to simply 'unless the position of the United States was substantially justified,' emphasizes the fact that the determination is one for

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[4] The EAJA applies to all civil tax litigation pending or commenced after October 1, 1981. Section 7430 applies to civil tax proceedings commenced after February 28, 1983. To the extent that a civil tax action is potentially subject to both provisions, then section 7430 applies. 28 U.S.C. § 2412(e).

the district court to make . . . ." *Id.* The Court also relied on a related provision of the EAJA which specified "that an agency's decision may be reversed only if a reviewing Court 'finds that the failure to make an award was unsupported by substantial evidence.'" *Id. See also* 5 U.S.C. § 504(c)(2).

The *Pierce* decision does not provide definitive guidance on the issue of the standard of review of cost determinations made by the Tax Court under section 7430. In stark contrast to the language of the EAJA, section 7430(c)(2)(A)(i) (1986) provides fees may be imposed if a party "establishes that position of the United States in the civil proceeding was unreasonable . . . ." Unlike the EAJA, there is no reference to "unless the court finds" in section 7430. Moreover, Congress has neither specified nor even suggested that "abuse of distion" standard in section 7430, or in any related provision thereof. This Congressional silence is, in fact, "deafening to those who have ears to listen." *Quern v. Jordan*, 440 U.S. 332, 365 (1979) (J. Brennan, concurring).

In addition, the application of the Court's rationale in *Pierce* to section 7430 cost determinations by the Tax Court would disregard the fact that the parties in Tax Court proceedings are mandated to stipulate. Tax Ct. R. Prac. 91(a).[5] In fact, a failure to stipulate to uncontested facts, would provide grounds for denying a taxpayer costs under section 7430. I.R.C. § 7430(b)(4) (1986). In contrast, parties litigating EAJA disputes

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[5] The EAJA applies only to actions in a court of the United States. As that term is defined, it excludes actions brought in the Tax Court. 28 U.S.C. § 451 ("any court created by Act of Congress the judges of which are entitled to hold office during good behavior"); *see* I.R.C. § 7443 (e) (Tax Court judges are appointed for set terms of 15 years). Therefore, the mandatory stipulation requirement, as found in Tax Ct. R. Prac. 91(a) is inapplicable to all EAJA disputes.

are not required to stipulate. Where facts are uncontested and stipulated an appellate court is "in as good a position as a trial court" to examine the record. *John R. Thompson Co. v. United States*, 477 F.2d 164, 167 (7th Cir. 1973). Therefore, the Rules of Practice and Procedure of the Tax Court eliminate the standard of review concern of judicial economy, which was present in *Pierce*.

II. THE CONFLICT OVER "POSITION OF THE UNITED STATES"

Section 7430 provides that a "prevailing party" may be awarded litigation costs. In turn, the phrase prevailing party, as applicable to cases commenced prior to December 31, 1985, is defined, in part, as a party who establishes that "the position of the United States in the civil proceeding was unreasonable." I.R.C. § 7430(c)(2). The circuits are divided on whether in making a determination under section 7430, a court ought to consider only the government's in-court litigating position or whether it ought to also consider the government's administrative position prior to the litigation. (App. 12a).

The Eighth, Tenth, Eleventh and District of Columbia Circuit have held that the "position of the United States" is determined by examining the government's in-court position. *Wickert v. Commissioner*, 842 F.2d 1005, 1008 (8th Cir. 1988); *Ewing and Thomas, P.A. v. Heye*, 803 F.2d 613, 615-16 (11th Cir. 1986); *Baker v. Commissioner*, 787 F.2d 637, 641-42 (D.C. Cir. 1986); *United States v. Balanced Financial Management, Inc.*, 769 F.2d 1440, 1450 (10th Cir. 1985). On the other hand, the First, Fifth, Sixth, and Ninth Circuits have taken a less restrictive approach holding that the government's position includes that espoused in its prelitigation administrative proceedings. *Comer v. Commissioner*, 856 F.2d 775, 779-80 (6th Cir. 1988); *Sliwa v. Commissioner*, 839 F.2d 602, 606-07 (9th Cir. 1988); *Powell v. Commissioner*,

791 F.2d 385, 388-92 (5th Cir. 1986); *Kaufman v. Egger*, 758 F.2d 1, 3-4 (1st Cir. 1985).

In the instant case the taxpayers argued, at each stage of the proceedings, that it was unreasonable under section 7430 for the Commissioner to take a position not supported by case law when the Commissioner is under a Congressional mandate to promulgate regulations to clarify the law and fails to do so. The taxpayers relied upon the well settled rule that where the Commissioner fails to issue regulations the ambiguity in the law is of the Commissioner's making, and it "must be held against him." *Gottesman & Co. v. Commissioner*, 77 T.C. 1149, 1157-58 (1981). Unquestionably, the issuance or failed issuance of regulations is purely an administrative act. Certainly, the failed promulgation of regulations is not an in-court position. As such, the taxpayer's very argument placed the Commissioner's administrative conduct squarely at issue.

However, the panel majority of the Seventh Circuit concluded that the "administrative posture of the Commissioner" was not sufficiently placed at issue.[6] (App.

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[6] This conclusion is clearly erroneous. The very issue framed for the Seventh Circuit was "whether innocent taxpayers, rather than the Commissioner of the Internal Revenue (hereinafter "Commissioner") should be forced to bear the financial burden of refining and clarifying the administration of the tax law, where the taxpayers have acted reasonably and the Commissioner charged by Congress to announce the law, never decided what it was himself?" (Appellants' BR at 2). In addition, the Commissioner, in addressing the split in the circuits concerning whether the prelitigation, administrative position of the Internal Revenue Service is included in the term "position of the United States," conceded that: "*This Court need not address the issue in this case,* however, because both the administrative and litigating positions of the United States here were based upon the Commission's interpretation of Section 1372(e)(1)." (Appellee's BR at 15.) In point of fact, the administrative position of the Commission and his conduct relative thereto were matters included in the stipulated record and were directly relevant to the legal theories urged by the taxpayers in prevailing on the merits. (App. 54A).

13a). While concluding that administrative posture was not at issue in one breath, the majority concedes in another "the taxpayers repeat in this court a good deal of administrative history" and "[a]t oral argument, the administrative history of the case was again presented." (App. 13a). These inherent contradictions within the majority opinion coupled with the very nature of the taxpayers' arguments leave no doubt that the administrative posture of the Commissioner is properly before this Court.

This Court has denied certiorari on a petition pertaining to section 7430 on two occasions. *Harrison v. Commissioner*, 854 F.2d 263 (7th Cir. 1988), *cert. denied*, 109 S.Ct. 1313 (1989); *reh'g denied*, 109 S.Ct. 1771 (1989); *Saul v. United States*, 835 F.2d 1439 (11th Cir. 1987), *cert. denied*, 108 S.Ct. 2921 (1988). The Solicitor General in both *Harrison* and *Saul* erroneously urged to this Court that the conflict over the position of the United States issue was definitively resolved by the amendments to section 7430 under the Tax Reform Act of 1986.[7] The 1986 Act's amendments apply only to those cases commenced after December 31, 1985, and as such are not at issue here. However, the amendments made to the definition of the position of the United States under the 1986 Act have "not eliminated the division between the circuits." *Humphreys v. United States*, 723 F. Supp. 1421 (D.C. Kan. 1989).

In *Weiss v. Commissioner*, 850 F. 2d 111 (2d Cir. 1988), the Second Circuit compared the pre-1986 and

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[7] The Tax Reform Act of 1986 added I.R.C. § 7430(c)(4) which provides:

> The term 'position of the United States' includes—
>
> (A) the position taken by the United States in the civil proceeding, and
>
> (B) any administrative action or inaction by the District Counsel of the Internal Revenue Service (and all subsequent administrative action or inaction upon which such proceeding is based.

I.R.C. § 7430(c)(4) (1986).

1986 version of section 7430 and found no material difference as to what circumstances constitute the position of the United States. *Id.* at 115-16. The Second Circuit in *Weiss then* placed itself in the thick of the disagreement between the circuits by embracing the view of the First, Sixth, and Ninth Circuits, which consider administrative posture. Subsequent to *Weiss*, the Fifth Circuit has construed section 7430, as amended by 1986 Act, to be materially different from its pre-1986 version. *Sher v. Commissioner*, 861 F.2d 131, 133-34 (5th Cir. 1988). Consequently, a conflict in the circuits remains under section 7430 notwithstanding the amendments by the 1986 Act.

Congress through the Technical and Miscellaneous Revenue Act of 1988 (TAMRA) has again amended section 7430. The amendments under TAMRA are effective for all proceedings commenced after November 10, 1988. This recent, change, similar to the 1986 Act, does not resolve the conflict over the position of the United States for purposes of recovering litigation costs.[8] Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647 § 6239, 102 Stat. 3745-46.

Under TAMRA, a taxpayer can recover administrative as well as litigation costs. I.R.C. § 7430(c)(1)(2). As always, a request for litigation costs is made directly to the court which adjudicated the underlying controversy.

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[8] TAMRA added I.R.C. § 7430(c)(7), which amended the definition of "position of United States" as follows:

> The term 'position of the United States' means—
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> (A) the position taken by the United States in a judicial proceeding to which subsection (a) applies, and
>
> (B) the position taken in an administrative proceeding to which subsection (a) applies as of the earlier of—
>
> (i) the date of the receipt by the taxpayer of the notice of the decision of the Internal Revenue Service Office of Appeals, or
>
> (ii) the date of the notice of deficiency.

I.R.C. § 7430(c)(7).

As to administrative costs, if the tax dispute is resolved short of litigation, a request for administrative costs is made to the Internal Revenue Service. If the tax dispute cannot be resolved administratively and proceeds to court, the taxpayer may seek an award of administrative costs from the court. A taxpayer must establish that the administrative position of the Commissioner was not substantially justified in both circumstances to be entitled to an award of administrative costs. I.R.C. § 7430(c)(4)(A)(i). However, it is unclear under the TAMRA amendments whether the position of the United States, for purposes of recovering *litigation costs*, includes the Commissioner's administrative posture. I.R.C. § 7430(c)(7). In short, an inquiry into the administrative posture of the Commissioner may be limited to situations where a taxpayer only seeks an award of administrative costs.

Further, it is emphasized that the effective date of the TAMRA amendments is November 10, 1988. In view of the backlog of tax cases as of the effective date of TAMRA, the position of the United States issue is potentially present in a significant number of outstanding cases even assuming TAMRA resolved the issue. For example, as of September 30, 1988 there were approximately 75,000 tax cases pending in the courts. 1988 IRS Ann. Rep. 35, 38.[9] Moreover, the derivative nature of Section 7430 litigation must be considered. For example, litigation regarding the 1986 amendments to section 7430 is now just reaching the circuits. In fact, only two circuits have had an opportunity to address the 1986 amendments. *Weiss*, 850 F.2d at 111; *Sher*, 861 F.2d at 133-34. The instant controversy extended over a five-year period. Assuming a similar time frame for other section 7430 matters, section 7430 cases relating to the pre-1988 amendments will be litigated into 1994. The existing cir-

[9] The 1988 Internal Revenue Service Annual Report provides that as of September 30, 1988 there were 70,815 cases docketed in the Tax Court, 2,679 tax refund controversies pending in the district courts, and 829 tax refund cases in the Claims Court.

cuit conflict cannot be so easily dismissed by the Solicitor General.

III. THE PURPOSE OF SECTION 7430 IS FRUSTRATED BY THE PANEL'S DECISION

The term "unreasonable" is not defined in section 7430. However, the legislative history of the section points out that a court's determination of whether the Commissioner's position or actions were unreasonable "is to be made on the basis of the *facts* and *legal precedents* relating to the case as revealed in the record." H. R. Rep. 404 97th Cong. 1st Sess. 12 (1981). The majority opinion fails to accord any weight to the Commissioner's failure to comply with the statutory mandate of Congress.[10] Rather, the majority deemed it sufficient to adopt the characterization of the underlying litigation as "complex" and therefore, excused the Commissioner's egregious conduct. (App. 17a). This stands in stark contrast to the well reasoned dissent of Judge Will, who, on the same record concluded:

> The Commissioner's failure to prescribe regulations was *unreasonable.* To later attempt to recover a deficiency from the petitioners based upon a statute which did not require them to do anything they failed to do, particularly when the I.R.S. had all the information it would have obtained under [proposed] regulations as finally promulgated was, *to put it mildly,* likewise unreasonable and abusive.

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[10] In deciding the substantive issue on the merits against the Commissioner, the Tax Court unequivocally condemned the actions of the Commissioner and specifically found that the Commissioner's failure to issue regulations frustrated Congress' intent to remove a trap for the unwary by "creating a new trap" for taxpayers. (App. 55-56a). Irrespective of the standard of review applied, in light of what the Commissioner knew at the time the litigation commenced as specifically found by the Tax Court in its decision on the merits, there is simply no support whatsoever to uphold the Seventh Circuit's affirmance.

Zinniel, 883 F.2d at 361 (J. Will dissenting) (emphasis added). (App. 25-26a).

Case law interpreting section 7430 establishes that the Commissioner cannot avoid liability under the hollow claim that an issue is one of first impression. *Huckaby v. United States*, 804 F.2d 297 (5th Cir. 1986). *Sansom v. United States*, 703 F. Supp. 1505, 1512 (N.D. Fla. 1988). Furthermore, although section 1372(e)(1) had not been interpreted by a court, the Commissioner's *application* of section 1372(e)(1) was in complete and utter disregard of well settled principles.[11] (App. 38-56a). Similarly, the contention by the Commissioner here that the issue was complex should not insulate the Commissioner, particularly when the Commissioner was *mandated* by statute to clarify the so-called complexity. By rejecting the taxpayer's request, the majority placed the burden on the taxpayers to clarify the tax law when Congress explicitly levied the burden on the Commissioner. This is error.[12]

In an attempt to salvage the Tax Court's unreasoned explanation of a denial of fees, the majority clung to the fact that the General Explanation of the Tax Reform Act of 1976 of section 1372 indicated a Congressional intent for a "filing." (App. 18a). The majority failed to recognize, unlike the Tax Court in the underlying litigation

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[11] It is undisputed that, but for the failure of the Commissioner to promulgate regulations in accordance with Congress' mandate, this litigation would never have occurred. (App. 24-25a).

[12] Unfortunately, and now ironically, the Tax Court in the underlying litigation on the merits deemed it unnecessary to consider the other additional arguments advanced by the taxpayers because the case was disposed of on the basis of the first of many legal arguments raised by the taxpayers. *Zinniel*, 89 T.C. at 370 (App. 56a). These arguments were presented to the Seventh Circuit to demonstrate the *absolute* absurdity of the Commissioner's position. The Seventh Circuit concluded that it was "unnecessary for us to deal extensively with the other arguments." (App. 18a). In point of fact, the majority failed to address the "other arguments" of *record* altogether.

that the General Explanation is "not part of the legislative history of the Tax Reform Act of 1976." *Zinniel* 89 T.C. at 336. (App. 51a). Further, the General Explanation only references a generic "filing." It does not require a filing with the Commissioner. It is undisputed that the taxpayers filed the affirmative refusal to consent with the corporation. The majority's reliance upon the General Explanation, which clearly is not legal precedent, let alone legislative history, is error as a matter of law.[13] The legislative history of section 7430 dictates that the Commissioner's conduct must be reviewed in light of legal precedents. H.R. Rep. No. 97-404, at 12.

A failure to correct the majority's error will result in severe repercussions in an environment of numerous tax law changes. In light of the constant Congressional tinkering with the tax laws, there are tax laws whose application and/or meaning are unclear. In some instances, as here, Congress has commanded the Commissioner to promulgate regulations on how its enactments are to be complied with. However, the Commissioner in

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[13] Ironically, the Commissioner through its own regulations has taken the position that reliance upon the General Explanation by a taxpayer does not insulate a taxpayer from liability under I.R.C. § 6661, which imposes a penalty upon taxpayers for substantial understatements. *See* Regs. § 1.6661-3(b)(2). Specifically, the General Explanation does not constitute "substantial authority," as that term is understood in section 6661. *Id.* In contrast to the General Explanation, a revenue ruling constitutes substantial authority under I.R.C. § 6661. *Id.* However, the Eighth Circuit has held that the government's reliance upon a revenue ruling is not substantial justification under the EAJA. *Keasler v. United States*, 766 F.2d 1227, 1232-34 (8th Cir. 1985) (fees awarded). As a result, a situation has evolved where the Seventh Circuit has concluded that sole reliance upon "authority" which does not constitute "substantial authority" under section 6661 is reasonable under section 7430. In contrast, the Eighth Circuit has ruled that reliance upon "authority" which does constitute substantial authority under section 6661 may not be substantially justified under section 7430. It is submitted that reliance upon the General Explanation or a revenue ruling is insufficient because neither is legal precedent.

many instances has not fulfilled that duty. In fact, the Commissioner has now unilaterally deemed it appropriate not to issue regulations under at least five Code sections where Congress has mandated that he do so. *See* Rev. Proc. 88-18 § 2.03.[14] In view of the Commissioner's current disregard for Congressional mandates, the Commissioner's conduct in the underlying litigation is capable of repetition. As a result, it is necessary to declare it *per se* unreasonable under section 7430 for the Commissioner to take a litigation position not supported by case law when the Commissioner is under a Congressional mandate to promulgate regulations to clarify the law and fails to do so.[15]

CONCLUSION

A denial of certiorari would harm the interests of all taxpayers and undermine the administration of our nation's voluntary self-assessment system of taxation. Accordingly the petition for a writ of certiorari should be granted.

Respectfully submitted,

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January 1990

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[14] The following sections require the Secretary of Treasury to issue regulations: (1) I.R.C. § 274(o); (2) I.R.C. § 338(i); (3) I.R.C. § 1092(b); (4) I.R.C. § 1254(b); and (5) I.R.C. § 1504 (a)(5). Under Rev. Proc. 88-18, the Commissioner has unilaterally decided to close the regulation projects under these sections.

[15] As Chief Justice Burger stated in another tax case "[t]he time has come for a rule with as 'bright' a line as can be drawn . . . ." *United States v. Boyle*, 469 U.S. 241, 248 (1985).

APPENDICES

APPENDIX A

IN THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

No. 88-1531

JOHN C. ZINNIEL and GAYLE A. ZINNIEL,
DAVID N. MERRYFIELD and JANE A. MERRYFIELD,
JAMES G. SAMUELS and MARGARET SAMUELS,
Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

Appeal from the United States Tax Court
Nos. 31100-84, 31101-84, 31102-84
Thomas B. Wells, *Judge.*

ARGUED NOVEMBER 7, 1988—DECIDED SEPTEMBER 6, 1989

Before CUDAHY and RIPPLE, *Circuit Judges*, and WILL, *Senior District Judge.**

RIPPLE, *Circuit Judge.* This is an appeal from the Tax Court's denial of the appellants' motion for litigation

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* The Honorable Hubert L. Will, Senior United States District Judge for the Northern District of Illinois, is sitting by designation.

costs. On June 6, 1984, the Commissioner of Internal Revenue (Commissioner) issued a notice of tax deficiency to the appellants. The appellants filed timely petitions in the Tax Court for the redetermination of the deficiencies. The Tax Court then ruled in favor of the taxpayers. On September 28, 1987, the appellants filed a motion for litigation costs pursuant to 26 U.S.C. § 7430 (now amended).[1] The Tax Court denied this motion on December 8, 1987. The appellants now appeal that denial. We conclude that the Commissioner's position in issuing a deficiency against the appellants was not unreasonable and affirm the order of the Tax Court.

I

BACKGROUND

A. *Introduction*

The appellants, John C. Zinniel and Gayle A. Zinniel, David N. Merryfield and Jane A. Merryfield, and James G. Samuels and Margaret Samuels are the taxpayers in this action (collectively taxpayers). The underlying action from which the taxpayers seek litigation costs dealt with whether a Subchapter S election for the taxpayers' corporation, Sierra Limited, had been properly terminated under the statute then governing such terminations, 26 U.S.C. § 1372(e)(1), and the proposed regulations thereunder.[2] The Commissioner contended that,

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[1] While section 2 of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986), redesignated the Internal Revenue Code of 1954 as the Internal Revenue Code of 1986, the taxable years and the significant underlying events in the present case antedate the Tax Reform Act of 1986. Unless otherwise noted, all references to the tax code in the underlying action will be to the Internal Revenue Code of 1954.

[2] Because the underlying events occurred during 1976 and 1977, we must look at the statutory language then governing terminations of Subchapter S elections. At that time, section 1372 was titled "Election by Small Business Corporation." The statutory lan-

in order to terminate properly a Subchapter S election, section 1372(e)(1) required new shareholders to file a document with the Internal Revenue Service (IRS) indicating that the shareholders refused to consent to the election. The taxpayers' position was that section 1372(e)(1) only required that the "refusal to consent" document be filed with the corporation. The Tax Court rejected the Commissioner's argument and held in favor of the taxpayers. *Zinniel v. Commissioner*, 89 T.C. 357 (1987). Having prevailed on the merits, the taxpayers filed a motion requesting that the Commissioner pay reasonable litigation costs incurred by the taxpayers in that action pursuant to 26 U.S.C. § 7430.

B. *The Underlying Transaction*

Sierra Limited (Sierra) is a Wisconsin corporation that was incorporated in 1976. At the time of incorporation, John Zinniel, David Merryfield, and James Samuels each owned one-third of the outstanding 900 shares of stock in Sierra. Sierra made an election to be taxed as a Subchapter S corporation. The election was first effective for Sierra's taxable year ending March 31, 1977. During 1977, Sierra decided that it would adopt a qualified pension plan. Because such a plan could not be established while Sierra was still an S corporation, it was necessary to terminate the S corporation status.

Prior to 1976, section 1372(e)(1) required new shareholders to consent affirmatively to the corporation's Subchapter S election within the time prescribed by the Sec-

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guage governing elections and terminations of Subchapter S status was revised in a general revision of the Subchapter S provisions. *See* Subchapter S Revision Act of 1982, Pub. L. No. 97-354, 96 Stat. 1669 (1982). The current provision governing the election and termination of Subchapter S status is now codified at 26 U.S.C. § 1362. The current section appearing at 26 U.S.C. § 1372 (titled "Partnership rules to apply for fringe benefit purposes") has no bearing on this case.

retary's regulations.[3] Inaction meant the S corporation status terminated. This arrangement resulted in the inadvertent termination of Subchapter S elections when new shareholders failed to file this statement of affirmative consent. Therefore, on October 4, 1976, Congress amended section 1372(e)(1) to require that a new shareholder must refuse affirmatively the Subchapter S election.[4] Inaction meant the S corporation status remained.

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[3] The termination provision was amended on October 4, 1976. Prior to that amendment, the language in section 1372(e)(1) read as follows:

> (e) Termination.—
>
> (1) New shareholders.—An election under subsection (a) made by a small business corporation shall terminate if any person who was not a shareholder in such corporation—
>
> (A) on the first day of the first taxable year of the corporation for which the election is effective, if such election is made on or before such first day, or
>
> (B) on the day on which the election is made, if such election is made after such first day,
>
> *becomes a shareholder in such corporation and does not consent to such election* within such time as the Secretary or his delegate shall prescribe by regulations. Such termination shall be effective for the taxable year of the corporation in which such person becomes a shareholder in the corporation and for all succeeding taxable years of the corporation.

Pub. L. No. 85-866, § 64(a), 72 Stat. 1606, 1651 (1958) (emphasis added).

[4] The revised language, effective for tax years beginning after December 31, 1976, read as follows:

> (e) Termination.—
>
> (1) New Shareholders.—
>
> (A) An election under subsection (a) made by a small business corporation shall terminate if any person who was not a shareholder in such corporation—
>
> (i) on the first day of the first taxable year of the corporation for which the election is effective, if such election is made on or before such first day, or

Upon consultation with counsel, the taxpayers were advised that the termination of a Subchapter S election could be effected by

> a gift of $3,000.00 worth of stock to each spouse of present stockholders and they, in turn, will file a notification with the Internal Revenue Service that they do not consent to be treated as stockholders in a Subchapter S Corporation.

Appellee's Br. at 4.[5] Therefore, on November 30, 1977, each of the three Sierra shareholders transferred thirty

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> (ii) on the day on which the election is made, if such election is made after such first day,
>
> *becomes a shareholder in such corporation and affirmatively refuses* (in such manner as the Secretary shall by regulations prescribe) *to consent to such election* on or before the 60th day after the day on which he acquires the stock.
>
> (B) If the person acquiring the stock is the estate of a decedent, the period under subparagraph (A) for affirmatively refusing to consent to the election shall expire on the 60th day after whichever of the following is the earlier:
>
> (i) The day on which the executor or administrator of the estate qualifies; or
>
> (ii) The last day of the taxable year of the corporation in which the decedent died.
>
> (C) Any termination of an election under subparagraph (A) by reason of the affirmative refusal of any person to consent to such election shall be effective for the taxable year of the corporation in which such person becomes a shareholder in the corporation and for all succeeding taxable years of the corporation.

Pub. L. No. 94-455, § 902(c)(3), 90 Stat. 1520, 1609 (1976) (emphasis added).

[5] The taxpayers' legal advisor, Patrick O'Neal, gave his clients this advice in a letter dated June 20, 1977. R.19 at Ex. 13-M. In November 1977, Mr. O'Neil requested of Attorney Russell Brannen that he further investigate the method to terminate a Subchapter S election under the new laws. Mr. Brannen then contacted the IRS on a number of different occasions seeking advice. In response

shares of Sierra stock to his wife. At that time, a document entitled "Refusal to Consent to Small Business Corporation Election" (Refusal to Consent) was executed by the wives and submitted to Sierra. It stated that the wives would not consent to Sierra's being treated as a small business corporation under section 1372 of the Internal Revenue Code (Code). This document—the focus of this litigation—was not filed with the IRS within the sixty-day period allowed by the statute for making such a refusal.

On the same date, November 30, 1977, a Form 5301—Application for Determination for Defined Contribution Plan—was filed with the IRS. This form recited that Sierra was a *corporation*, not an S corporation. The IRS issued a favorable determination letter regarding the qualified status of Sierra's employee pension plan.

Sierra filed its income tax return on March 31, 1978 and attached a letter stating that Sierra's status as an S corporation had terminated when the new shareholders had affirmatively refused to consent to the election. The Refusal to Consent was not attached to the letter. At the request of the IRS, on December 28, 1978, Sierra's accountant forwarded to the IRS the Refusal to Consent.

For the years ending March 31, 1978 and March 31, 1979, Sierra reported its taxable income as if it were a

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to his inquiries, Mr. Brannen was informed by the IRS that "regulations had not yet been proposed or adopted." R.19 at ¶ 19. It is clear that, by contacting the IRS, the taxpayers made a good-faith attempt to properly file a termination of Sierra's Subchapter S status. However, there is no evidence that the IRS affirmatively misrepresented the Commissioner's position—saying only that no regulations had been proposed or adopted—and the parties themselves stipulated that "Mr. O'Neil, who is an experienced tax practitioner and is familiar with the law regarding the termination of and consents regarding elections of Subchapter S corporations, assumed that the Internal Revenue Service would have to be notified in writing of such refusal to consent to said election." R.19 at ¶ 15.

corporation. The parties stipulated that, at all times relevant to this controversy, there were no regulations, letter rulings, or revenue procedures regarding the new method for terminating a Subchapter S election. R.19 at 9. Each of the three couples also reported their income and any earnings from Sierra as if Sierra were a corporation. On April 17, 1980, Proposed Treasury Regulation 1.1372-3(b)(3) was published under Code section 1372(e)(1).[6] This section set forth the requirements for revoking an election as a Subchapter S corporation.

C. *The Underlying Litigation*

The Commissioner subsequently determined that Sierra's Subchapter S election had not been terminated effectively, and that taxpayers were therefore required to report on their income tax returns for the taxable years in issue the difference between the amount they paid (assuming that Sierra was a corporation) and the amount they owed because the company was still deemed by the IRS to be an S corporation. The Commissioner issued statutory notices of deficiency dated June 6, 1984 that determined deficiencies in taxpayers' income taxes

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[6] Proposed Treasury Regulation § 1.1372-3(b)(3) provided as follows:

> (3) *Prior Defective Affirmative Refusals to Consent.* A timely defective affirmative refusal to consent filed by a shareholder with the Internal Revenue Service prior to [the date which is 30 days after the date on which these regulations are published in the Federal Register as a Treasury Decision] will be considered effective by the Internal Revenue Service if the names of both the shareholder and the corporation are set forth in the statement of affirmative refusal to consent. For this purpose, a defective affirmative refusal to consent is one that was not properly filed or did not contain all the information required by paragraph (b)(1)(i) or (2) (as the case may be) of this section.

45 Fed. Reg. 26,092, (1980) (proposed April 17, 1980).

for the taxable years ending December 31, 1978 and December 31, 1979.

Taxpayers filed timely notices for review of these deficiencies by the Tax Court. They claimed that the new shareholders affirmatively had refused to consent to the Subchapter S election by filing the refusal to consent with Sierra within sixty days of the new shareholders' acquisition of the stock. Taxpayers claimed that the plain language of the statute did not require them to file this refusal to consent—or any other documentation—with the IRS. There were no regulations in force requiring a filing with the IRS. In the alternative, taxpayers argued that the Proposed Treasury Regulation [7] cured any defect in the manner of the election. The Commissioner countered by arguing that, since taxpayers had not filed their refusal to consent with the IRS, no effective termination of the Subchapter S election had occurred. In the Commissioner's view, this result was required by the statute, section 1372(e)(1), even without regulatory supplementation.

The Tax Court decided in favor of the taxpayers. It held that the plain wording of the statute does not require that new shareholders file an affirmative refusal to consent to a corporation's Subchapter S election. Nor could it find that the legislative history reflects an unequivocal congressional intention to require that the affirmative refusal to consent be filed with the IRS in order to effectuate termination. Finally, it held that the proposed regulations " 'carry no more weight than a position advanced on brief.' " *Zinniel v. Commissioner*, 89 T.C. at 369 (quoting *F.W. Woolworth Co. v. Commissioner*, 54 T.C. 1233, 1265 (1970)); *see also LeCroy Research Sys. Corp. v. Commissioner*, 751 F.2d 123, 127 (2d Cir. 1984) ("Proposed regulations are suggestions made for comment; they modify nothing.").

[7] *See supra* note 6.

D. *Request for Litigation Costs Pursuant to Section 7430*

Taxpayers, alleging that they satisfied the requirements of 26 U.S.C. § 7430—having *substantially prevailed* with respect to the amount in controversy and claiming that the *government's position* in the suit *was unreasonable*—filed a motion for litigation costs under 26 U.S.C. § 7430. The Tax Court denied the motion. It held that taxpayers had not established that the position of the government was unreasonable. *Zinniel v. Commissioner*, No. 31100-84, mem. sur order at 4 (T.C. Dec. 8, 1987); R.33 at 4 [hereinafter Mem. sur order]. In the Tax Court's view, the issue involved a complex analysis of section 1372(e)(1) and its legislative history. Consequently, although the Tax Court disagreed with the Commissioner, it did not think that the Commissioner's position was unreasonable in light of what he knew at the time of the litigation. The Tax Court thus held that taxpayers had not satisfied their burden of proving that the position of the government was unreasonable. The taxpayers now appeal.

II

ANALYSIS

A. *Standard of Review*

As the appellants point out, a survey of the case law reflects a split among the circuits on the appellate standard of review of cost determinations under section 7430. The Eighth Circuit has held that a denial of costs and fees under section 7430 is reviewed under the "abuse of discretion" standard. *Berks v. United States*, 825 F.2d 1263 (8th Cir. 1987), *remanded for findings, later appeal*, 860 F.2d 841 (8th Cir. 1988). In contrast, the Ninth Circuit has recently concluded that the Tax Court's determination of the reasonableness of the Commissioner's position under section 7430 presents a mixed question of law and fact, and is subject to *de novo* review. *Sliwa v. Commissioner*, 839 F.2d 602, 605 (9th Cir.

1988). In *Harrison v. Commissioner*, 854 F.2d 263 (7th Cir. 1988), *cert. denied*, 109 S. Ct. 1313 (1989), we analyzed a question under section 7430 but did not explicitly articulate the standard of review.

In our view, the decision of the Supreme Court of the United States in *Pierce v. Underwood*, 108 S. Ct. 2541 (1988), now provides definitive guidance on the issue. At issue was an award of attorney's fees under the Equal Access to Justice Act (EAJA). *See* 28 U.S.C. § 2412(d). In *Pierce*, the Supreme Court squarely held that a district court's determination that a department head's position was not "substantially justified," was reviewable under the abuse of discretion standard. In reaching that conclusion, the Court first noted that the language of the EAJA suggested such a result because it required a fees award "unless the court finds that" (rather than simply "unless") the United States' position was substantially justified. The Court also noted that "'as a matter of the sound administration of justice,'" 108 S. Ct. 2547 (quoting *Miller v. Fenton*, 474 U.S. 104, 114 (1985)), a deferential standard of review was preferable. The Court stated that:

> the question [of fees] will turn upon not merely what was the law but what was the evidence regarding the facts. By reason of settlement conferences and other pretrial activities, the district court may have insights not conveyed by the record, into such matters as whether particular evidence was worthy of being relied upon, or whether critical facts could easily have been verified by the Government. Moreover, even where the district judge's full knowledge of the factual setting can be acquired by the appellate court, that acquisition will often come at unusual expense, requiring the court to undertake the unaccustomed task of reviewing the entire record, not just to determine whether there existed the usual

> minimum support for the merits determination made by the fact-finder below, but to determine whether urging of the opposite merits determination was substantially justified.

Id. Even when the fees determination is based upon the evaluation of a purely legal issue governing the litigation, continued the Court, *de novo* review will not be time well spent. "[T]he investment of appellate energy will either fail to produce the normal law-clarifying benefits that come from an appellate decision on a question of law, or else will strangely distort the appellate process." *Id.* at 2548. Finally, noted the Court, application of an abuse of discretion standard will permit the "needed flexibility," *id.* at 2549, in dealing with "such a multifarious and novel question, little susceptible . . . of useful generalization." *Id.* at 2548.

We believe that the same considerations that the Supreme Court found controlling in the EAJA situation also should be controlling with respect to section 7430. This section authorizes, rather than commands, the court to make an award—"the prevailing party may be awarded a judgment"—for reasonable litigation costs. 26 U.S.C. § 7430(a); *see Feinberg v. United States*, 628 F. Supp. 12, 13 (E.D. Pa. 1985); *Randazzo v. United States Dep't of Treasury*, 581 F. Supp. 1235, 1236 (W.D. Pa. 1984), *appeal dismissed*, 751 F.2d 145 (3d Cir. 1984). Moreover, the same considerations of judicial economy present in the EAJA situation are also present in the section 7430 context. *Cf. Mars Steel Corp. v. Continental Bank N.A.*, No. 88-1554, slip op. at 8-11 (7th Cir. July 20, 1989) (en banc) (applying the same consideration to the appellate review of sanctions under Rule 11). Accordingly, we must conclude that the determination of the Tax Court is reviewable under an abuse of discretion standard.

B. *The Merits*

Having addressed the only threshold issue properly before us,[8] we must now determine whether the Tax Court abused its discretion when it denied litigation costs to the taxpayers.

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[8] There is another potential threshold issue in litigation of this sort. As we noted in *Harrison v. Commissioner*, 854 F.2d 263, 265 n.3 (7th Cir. 1988), *cert. denied*, 109 S. Ct. 1313 (1989), the circuits are divided on whether, in making a determination under section 7430, a court ought to consider only the government's in-court litigating position or whether it ought to consider the government's administrative position prior to the litigation as well. As we noted in *Harrison*, this circuit has not yet been confronted with a situation in which it has been necessary for us to confront squarely the question. Moreover, for cases commencing after December 31, 1985, Congress has settled the issue by providing that the administrative position of the government can be considered. Tax Reform Act of 1986, Pub. L. No. 99-514, § 1551(a)-(g), 100 Stat. 2085, 2752, 2753 (1986) (later amended and codified as 26 U.S.C. § 7430(c)(7).

In this case, we need not determine whether, for cases commencing before January 1, 1986, the administrative position of the government ought to be considered. In dealing with the submission of the taxpayers on their motion for litigation costs, the Tax Court noted that:

> Petitioners' motion only states that respondent's "position and actions" were unreasonable "in that the Respondent took the position that the new shareholders must file an affirmative refusal to consent . . . with the . . . Service in order to terminate the . . . Sub-Chapter S Election." Petitioners then set forth 14 numbered paragraphs that petitioners represent to be the facts supporting the statement. Some of the paragraphs contain petitioners' legal conclusions and facts not in evidence, while other paragraphs contain facts that do not support petitioners' statement with respect to respondent's position. As we read petitioners' motion, the crux of petitioners' argument is that respondent's position was unreasonable because it was without any basis in law, and it is that argument that we specifically address in the text above.

Petitioners' Memorandum in Support of Litigation Costs, which was filed subsequent to petitioners' Motion for Litiga-

1.

We begin by reviewing the requirements of the statute permitting the award of fees. There appears to be no dispute between the parties with respect to the essential re-

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> tion Costs, has been considered and does not raise any new or meritorious arguments with respect to this issue.

Zinniel v. Commissioner, No. 31100-84, mem. sur order at 5-6 n.7 (T.C. Dec. 8, 1987); R.33 at 5-6 n.7. Although the taxpayers repeat in this court a good deal of the administrative history of the litigation, they do not take specific issue with the Tax Court's characterization of their motion. Nor do they address squarely the conflict among the circuits and argue that we ought to adopt the position of those circuits that have considered the government's administrative position. They only suggest that we ought to consider "all the facts and circumstances surrounding the proceeding." Appellants' Br. at 10 (quoting *In re Testimony of Arthur Andersen & Co.*, 832 F.2d 1057, 1060 (8th Cir. 1987)). This statement is hardly sufficient to place in issue the administrative posture of the Commissioner, even if we were to assume, *arguendo*, that the Tax Court had misconstrued the tenor of the taxpayers' argument. We have noted on numerous occasions that it is the responsibility of the appellant to present to this court reasoned argument, including citation of authority, on each point tendered for consideration by the court. An appellant is required by Rule 28(a)(4) of the Federal Rules of Appellate Procedure to present in its brief to the appellate court the issues that it desires to litigate and to support its arguments on those issues with appropriate judicial authority. *See Zelazny v. Lyng*, 853 F.2d 540, 542 n.1 (7th Cir. 1988); *Sere v. Board of Trustees of Univ. of Illinois*, 852 F.2d 285, 287-88 (7th Cir. 1988); *United States v. Shriver*, 842 F.2d 968, 972 n.5 (7th Cir. 1988); *Beard v. Whitley County REMC*, 840 F.2d 405, 408 (7th Cir. 1988). " 'It is not the obligation of this court to research and construct the legal arguments open to parties, especially when they are represented by counsel.' " *Beard*, 840 F.2d at 408-09 (quoting *Sanchez v. Miller*, 792 F.2d 694, 703 (7th Cir. 1986), *cert. denied*, 479 U.S. 1056 (1987)). At oral argument, the administrative history of the case was again presented. However, like our colleague in the Tax Court, we construe that presentation as designed to illustrate the unreasonableness of the *legal* position taken by the Commissioner with respect to the tax liability of the taxpayers. Moreover, a litigant may not raise new arguments during oral argument. *See, e.g., Dovenmuehle v. Gilldorn Mortgage Midwest Corp.*, 871 F.2d 697, 701 n.5 (7th Cir. 1989); *Lim v. Central*

quirements of section 7430. There are three elements that taxpayers must satisfy before they may recover litigation costs. First, taxpayers must exhaust all administrative remedies available to them. The parties agree that the taxpayers met this first requirement. Second, taxpayers must show that they are the "prevailing party" as that term is defined in section 7430(c)(2): taxpayers must prove that they substantially prevailed with respect to the amount in controversy and that the position of the United States in the civil proceeding was unreasonable.[9] The government does not dispute that the taxpayers substantially prevailed. Therefore, the only issue in dispute is whether the position of the United States in the civil proceeding was unreasonable. Third, the taxpayers must show that the amount they have requested for attorney's fees is reasonable. Because the Tax Court denied taxpayers' motion without considering this requirement, this issue is not before this court.

There are two other important matters upon which the parties are in agreement. First, all acknowledge that the taxpayers have the burden of establishing the unreasonableness of the government's position. *See Harrison v. Commissioner*, 854 F.2d at 265. Second, the parties also

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DuPage Hosp., 871 F.2d 644, 648 (7th Cir. 1989) ("oral argument in this court . . . [is] too late for advancing new (or what is the same thing, reviving abandoned)" arguments). Of course, the *legal* position of the Commissioner—that notice of the election to discontinue Subchapter S status must be reported to the IRS—has remained the same throughout the administrative and judicial proceedings.

[9] This language was altered by the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085, 2752, which was approved October 22, 1986, to require that a taxpayer must "establish[] that the position of the United States in the civil proceeding was not substantially justified." Section 7430 was amended again in 1988 and the current version is codified at 26 U.S.C. § 7430(c)(4)(A). Because this action was filed September 4, 1984, before the amendment became effective, the unamended language is applicable.

agree that the Commissioner's failure to prevail in the underlying litigation does not require a determination that his position was unreasonable. *See Huckaby v. United States Dep't of Treasury*, 804 F.2d 297, 299 (5th Cir 1986).

2.

Since our task is to review the judgment of the Tax Court under an abuse of discretion standard, we must focus, within the analytical framework just described, on the reasons given by that court for its determination that the Commissioner's position was not unreasonable. Because that court's explanation is indeed central to our review—and review under an abuse of discretion standard, while deferential, must still be a meaningful review [10]—we do, of course, welcome, and indeed expect, a trial court to provide a reasoned explanation for its result. In this case, the Tax Court's explanation is indeed terse. However, it is obvious that the trial judge intended that it be read together with the opinion in the underlying deficiency litigation. Therefore, we shall examine the opinions together.

As the Tax Court noted, the Commissioner's position was formulated at a time when the revised version of section 1372(e)(1) had not yet been interpreted by any court. The statutory language—read without reference to the regulations that the Secretary was mandated to provide but did not provide—gives incomplete directions with respect to the manner in which the affirmative refusal to consent is to be made. The Commissioner took the position that, despite the absence of regulations, the taxpayers were required to notify formally the IRS of their refusal to consent within sixty days. In rejecting this position, the Tax Court noted that the plain wording of the statute did not require such a filing:

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[10] *See In re Ronco, Inc.*, 838 F.2d 212, 217 (7th Cir. 1988) ("Review under the abuse of discretion standard does not mean no appellate review.").

> Congress, in adopting the words contained in section 1372(e)(1), did not preclude the Secretary from prescribing a method other than one which requires new shareholders to file an affirmative refusal to consent with the Service. Therefore, we hold that the plain meaning of the relevant language under section 1372(e)(1) does not require a new shareholder to file an affirmative refusal to consent with the Service.

89 T.C. at 363 (footnote omitted). The court then examined whether, despite the absence of such an affirmative mandate in the statute, it would be contrary to the legislative purpose not to require such a filing with the IRS. The plain wording of the statute, said the court, may only be overridden by *unequivocal* evidence that "Congress intended that section 1372(e)(1) would, by that section's own terms, and without any regulatory requirement, require the filing of an affirmative refusal to consent with the Service." 89 T.C. at 364. The court then embarked upon a comparison of the previous statutory and regulatory scheme [11] with the new scheme.[12] It

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[11] The court explained the earlier scheme as follows:

> For taxable years beginning before January 1, 1977, section 1372(e)(1) required new shareholders in a corporation to consent to a corporation's subchapter S election under section 1372(a) within the period of time prescribed by the Secretary in order to avoid a termination of the corporation's election. Sec. 1.1372-3(b), Income Tax Regs., required that the consent "be made in a statement filed (with the internal revenue officer with whom the election is filed) within the period of 30 days beginning with the day on which such person becomes a new shareholder." The Commissioner granted extensions of time for filing consents if "there was reasonable cause for the failure to file" the consents, and certain other conditions were satisfied. Sec. 1.1372-3(c), Income Tax Regs.

89 T.C. at 364-65 (footnotes omitted).

[12] With respect to the new scheme, the Tax Court wrote:

> As part of the Tax Reform Act of 1976, Congress changed the statutory consent requirement to a statutory affirmative

noted that the legislative history, while it spoke in several places of filing with the IRS, did not *unequivocally* manifest a congressional intent to require such a filing in the absence of regulations. Therefore, the court concluded:

> Based upon the sparse legislative history underlying section 1372(e)(1) and the General Explanation, we are not prepared to find that Congress was attempting to require by *statute* that new shareholders file affirmative refusals to consent with the Service, and thereby preclude the Secretary from prescribing some other manner for new shareholders to affirmatively refuse to consent under section 1372(e)(1). We therefore hold that the plain meaning of the statutory language contained in section 1372(e)(1) is not "plainly at variance with the policy of the legislation as a whole." Thus, we follow the statute's literal words, which do not require that an affirmative refusal to consent be filed with the Service in order to terminate a subchapter S election.

89 T.C. at 367.

We agree with the Tax Court that its conclusion in the underlying litigation "involved a complex analysis of section 1372(e)(1) and that section's legislative history, as well as the regulations underlying section 1372(e)(1)." Mem. sur order at 6. We also agree that the Commissioner's position with regard to that legislative change can hardly be termed "unreasonable"—despite his failure to provide "unequivocal" evidence of a legislative understanding not plainly evident from the text of the statute. The basic thrust of the 1976 legislative change was to

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> refusal to consent requirement and changed the 30-day regulatory period for filing the consent with the Service to a 60-day statutory period for making an affirmative refusal. Sec. 902(c)(3), Tax Reform Act of 1976. 90 Stat. 1609.

89 T.C. at 365.

alter *what* had to be reported. Under the prior law, Subchapter S status had been inadvertently lost through the failure of new shareholders to consent affirmatively to its continuation. To avoid that injustice, under the new scheme, only refusals to continue had to be reported. However, Congress' decision to change *what* had to be reported in order to abolish a specific pitfall does not indicate necessarily that Congress also had determined to excuse *all* notification to the Commissioner. Information on the status of the corporate entity had the time of its election of that status are important to the administration of the tax laws. *See, e.g., Frentz v. Commissioner*, 375 F.2d 662 (6th Cir. 1967) (requiring strict compliance with Subchapter S election requirements). The Commissioner cannot be said to have acted unreasonably in assuming that, just because Congress addressed the question of *what* had to be filed, Congress was also abolishing so important a tool in tax enforcement as notification to the IRS. Indeed, the legislative history can be read—although not unequivocally read—as assuming that such notification would be given. *See Zinniel*, 89 T.C. at 366 (noting that the General Explanation contains several references to filing).

On this basis, we cannot disturb the Tax Court's determination that the Commissioner's position, while erroneous, was not unreasonable. It is therefore unnecessary for us to deal extensively with the other arguments of the taxpayers which do not affect this fundamental conclusion of the Tax Court. Accordingly, the judgment of the Tax Court is affirmed.

AFFIRMED

WILL, *Senior District Judge*, dissenting. While I agree with the majority that the proper standard of review under 26 U.S.C. § 7430 is an abuse of discretion standard, I believe the Tax Court's decision in this case that the Commissioner's position was not unreasonable is incorrect and an abuse of discretion.

The Commissioner's conduct in this proceeding was anything but reasonable. In the October 4, 1976 amendments to 26 U.S.C. § 1372(e)(1) Congress specifically directed the Commissioner to promulgate regulations to prescribe the manner in which a new shareholder of a subchapter S corporation would "affirmatively refuse[] . . . to consent to such [subchapter S corporation] election . . . ." Pub. L. No. 94-455, § 902(c)(3), 90 Stat. 1520, 1609 (1976). It is undisputed that the Commissioner had not prescribed such regulations by the time a year later, in November 1977, that the petitioners sought to change the status of their subchapter S corporation. On November 30, 1977, three new shareholders filed a Refusal to Consent to Small Business Corporation Election with the corporation. It was not until April 17, 1980, nearly two and one-half years later, and approximately three and one-half years after Congress directed that regulations be issued, that the Commissioner even promulgated *proposed regulations*. As the majority correctly points out, *ante* at 8 (citing the Tax Court), proposed regulations are not binding and, in any event, these were issued long after the petitioners' actions in this case.

Notwithstanding the fact that the Commissioner had not timely prescribed the manner by which new shareholders would be required affirmatively to refuse to consent, the IRS was given early and ample notice that such an affirmative refusal to consent had been made here. On November 30, 1977, the same date the refusal to consent was filed with the corporation, the corporation's officers filed an Application For Determination For Defined Contribution Plan (a Form 5301) with the Com-

missioner reflecting, that for federal tax purposes, Sierra Ltd. was a general corporation, not a subchapter S corporation. Because the IRS knew that Sierra Ltd. had previously been a subchapter S corporation, it also had to know that some action had been taken to convert it from a subchapter S corporation to a general corporation. Thereafter, on February 23, 1978, the Commissioner issued a favorable determination of the (new corporate status) contribution pension plan.

In June 1978, Sierra Ltd. filed its income tax return for the 1977-78 fiscal year, the year of the change in status. In its return, Sierra Ltd reported the termination of its status as a subchapter S corporation. Attached to the June 1978 tax return was a letter stating the following:

Dear Sirs:

In accordance with the requirements of Regulation Section 1.1372-4(b)(1)(iii), this is to notify you of the termination of the election to be subject to Sub-Chapter S made by Sierra Limited, Post Office 247, North Prairie, Wisconsin 53153. The election was terminated by the failure of new shareholders to consent to the election within the required time. On November 30, 1977, Jane Merryfield, Margaret Samuels and Gayle Zinniel each acquired thirty shares of Sierra Limited. They subsequently failed to consent to the election to treat Sierra Limited as a Sub-Chapter S corporation.

SIERRA LIMITED

By: /s/ John C. Zinniel
JOHN C. ZINNIEL
Agent

The document reflecting the refusal to consent ("Refusal to Consent to Small Business Corporation Election") was not attached to Sierra's June 1978 tax return. However, on December 28, 1978, pursuant to a request from the IRS, Sierra's accountant filed a copy of the refusal to consent. It was not until June 6, 1984, six years after the return was filed and five and one-half years after the refusal to consent was filed with the IRS, that the Commissioner decided to issue a notice of deficiency with respect to the years 1978 and 1979, claiming, without any case authority or applicable regulations, that the petitioners' attempted affirmative refusal was ineffective because the signed document indicating a refusal to consent had not been timely submitted to the IRS.

The unreasonableness of the IRS' position is further evidenced by a comparison between section 1372 prior to the 1976 amendment and section 1372 as amended in 1976. Section 1372(e)(1)(A) was amended in 1976, effective for the tax years in question, to require that new shareholders affirmatively refuse to consent to a subchapter S election in order to terminate such election. Previously, there was no requirement for new shareholders to act in order to terminate the subchapter S status. Instead, a new shareholder had to consent to the status by filing a consent with the IRS in order to maintain the status. This created a problem in that taxpayers were inadvertently terminating their corporations' subchapter S status by failing to file their consent. Thus, under the old law the petitioners here would have effectively terminated their subchapter S corporation status by doing nothing.

By amending section 1372, Congress attempted to prevent unintentional terminations of subchapter S corporation status. The amendment mandated that the Commissioner promulgate regulations prescribing how such an affirmative refusal was to be made. It is undisputed that at the time the petitioners elected to change their cor-

porate status, and for more than three years thereafter, the Commissioner had not promulgated any regulations or revenue procedures or issued any letter rulings. Ironically, had the Commissioner prevailed before the Tax Court, it would have to have been because the failure to promulgate regulations "inadvertently" prevented the petitioners from properly changing the status of Sierra Ltd., a truly ironic result.

Indeed, the Commissioner's position before the Tax Court was that the petitioners had failed effectively to terminate their subchapter S corporate status because they did not send their affirmative refusal to the IRS although, as the Tax Court held, the plain language of the statute (in the absence of any regulations prescribed by the Commissioner) did not require such action. While the Commissioner's long delay in prescribing such regulations may sometimes be excusable, it is difficult to believe that not even issuing a ruling or temporary regulations was reasonable in this case. Even worse, it was not reasonable for the Commissioner thereafter to contend that taxpayers failed to comply with regulations which had not yet been promulgated, particularly when the IRS had all the information it would have obtained under the regulations as ultimately promulgated. As previously indicated, a copy of the refusal to consent was filed with the IRS in December 1978, more than a year before proposed regulations were issued and five and one-half years before the deficiency was asserted.

While the majority acknowledges, *ante* at 5-6 n.5, that the petitioners attempted in good faith to comply with whatever procedures were necessary, it apparently attaches little or no significance to their efforts. Their tax attorney sought advice from the Milwaukee District Director's office on November 11, 1977 with respect to the new method for termination of subchapter S corporations and was advised that no information was available and that he should communicate with the District Director.

The taxpayers' attorney wrote to the District Director on November 15, 1977 and was called in response by an office representative who indicated that no regulations had yet been promulgated. The Commissioner's failure to issue regulations as mandated by Congress, or even a ruling, clearly contributed to the taxpayers' dilemma.

Terminating a subchapter S corporate status, it should be noted, is within the shareholders' discretion. The Commissioner does not approve or disapprove of this action. Thus, there was no harm to the Commissioner and, as noted previously, the IRS had effective notice of the petitioners' refusal to consent as early as November 30, 1977.

The Commissioner correctly points out that his position during this litigation was not contrary to any case law. There were no reported cases with respect to an alleged improper refusal to consent under section 1372. However, the Commissioner cannot escape liability under section 7430 for unreasonable conduct simply because a statute is new and its application untested. Indeed, the purpose of section 7430 is to "deter abusive actions and overreaching by the Internal Revenue Service and . . . enable individual taxpayers to vindicate their rights regardless of their economic circumstances." *In re The Testimony of Arthur Andersen & Co.*, 832 F.2d 1057, 1060 (8th Cir. 1987) (citing *Kaufman v. Egger*, 584 F. Supp. 872, 879 (D. Me. 1984)). The Commissioner's conduct here in failing to issue regulations and then seeking to assess deficiencies for failure to comply with them before they were issued was abusive and overreaching.

The Tax Court's decision in the underlying litigation confirms the unreasonableness of the Commissioner's position.

> [W]e fail to understand how the Secretary could fail to issue any temporary or final regulations prescribing the procedures for new shareholders to affirmatively refuse to consent to subchapter S elections

when there was a statutory direction to issue such regulations (the statute required that the new shareholders affirmatively refuse to consent "in such manner as the Secretary *shall* by regulations prescribe") (Emphasis supplied.) Furthermore, in light of the prior regulatory requirement under section 1.1372-3, Income Tax Regs., that new shareholders file consents to the continuation of subchapter S elections with the Service, it does not appear that it would have been difficult to issue temporary regulations prescribing similar filing requirements for new shareholders to affirmatively refuse to consent. Finally, if the Commissioner and the Secretary deemed a filing requirement to be crucial to their ability to administer section 1372(e)(1), they should have issued temporary or final regulations prescribing the requirement. It is obvious that the amendment of section 1372(e)(1) was an attempt by Congress to remove a trap for the unwary, i.e., an inadvertent termination of a subchapter S election. The failure to issue temporary or final regulations under the new statutory section frustrated that purpose by creating a new trap, i.e., an inadvertent failure to terminate a subchapter S election.

Zinniel v. Commissioner, 89 T.C. 357, 369-70 (1987) (footnotes omitted).

The Commissioner contends that it was reasonable for the taxpayers to ~~expect~~ to have to file their affirmative refusals with the IRS because otherwise the IRS would not be sure that the corporation had made a timely election. While there may be some merit to this argument in general, it is not persuasive in this case. This transaction was not done in any way to conceal the action from the IRS and had there been an IRS regulation in place which required a filing with the IRS, there is no evidence suggesting that it would have been done. Moreover, the IRS had all the information it would have received under

the regulations, since a copy of the refusal was filed in December 1978.

As I have previously noted, the taxpayers' attorney inquired of the IRS at least twice as to what steps were necessary—they were ready to comply. The new shareholders filed a notice of refusal with the company. The company attached a letter with its next tax return indicating that this had been done. As soon as requested, and long before even proposed regulations were issued, it filed a copy of the Refusal to Consent with the IRS. Even before that, the company filed for approval of a qualified pension plan (which it could not have done under subchapter S) and received approval of the plan from the Commissioner.

Section 7430 does not define what is unreasonable but the legislative history suggests that the Commissioner's conduct is to be reviewed in light of the then prevailing law and regulations, in addition to the particular facts of the case. H.R. Rep. No. 97-404, 97th Cong., 1st Sess. 12 (1981); *Arthur Andersen*, 832 F.2d at 1060. It is intended to deter exactly the kind of unreasonable and inexcusable conduct engaged in by the IRS here. The taxpayers have been put to considerable effort and expense to defend against a deficiency which, as the Tax Court found, should never have been asserted. They should at least be reimbursed for their expenses in doing so.

The Tax Court's decision that the Commissioner's conduct was not unreasonable, since the case was complex and one of first impression and because the Commissioner was attempting to enforce the tax laws is, I believe, clearly an abuse of discretion. The Commissioner's failure to prescribe regulations was unreasonable. To later attempt to recover a deficiency from the petitioners based on a statute which did not require them to do anything they failed to do, particularly when the IRS had all the information it would have obtained under the regulations

as finally promulgated was, to put it mildly, likewise unreasonable and abusive. Section 7430 was enacted to keep from putting taxpayers through such an unjustified and expensive experience and to compensate taxpayers who are victims of such IRS conduct. Accordingly, I respectfully dissent from the majority's finding that the Tax Court did not abuse its discretion in holding the IRS and Commissioner's conduct in this case reasonable and section 7430 inapplicable.

A true Copy:

Teste:

Clerk of the United States Court of Appeals for the Seventh Circuit

UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT
Chicago, Illinois 60604

SEPTEMBET 6, 1989

Before

HON. RICHARD D. CUDAHY, *Circuit Judge*

HON. KENNETH F. RIPPLE, *Circuit Judge*

HON. HUBERT L. WILL, SR., *District Judge* *

No. 88-1531

JOHN C. ZINNIEL AND GAYLE A. ZINNIEL,
DAVID N. MERRYFIELD AND JANE A. MERRYFIELD,
JAMES G. SAMUELS AND MARGARET SAMUELS,
Petitioners-Appellants,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

Appeal from the United States Tax Court
Nos. 31100-84, 31101-84, 31102-84
Thomas B. Wells, Judge

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* The Honorable Hubert L. Will, Senior United States District Judge for the Northern District of Illinois, is sitting by designation.

This cause was heard on the record from the United States Tax Court, and was argued by counsel.

On consideration whereof, IT IS ORDERED AND ADJUDGED by this Court that the decision of the United States Tax Court is AFFIRMED, with costs, in accordance with the opinion of this Court filed this date.

UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT
Chicago, Illinois 60604

OCTOBER 18, 1989

Before

HON. RICHARD D. CUDAHY, *Circuit Judge*

HON. KENNETH F. RIPPLE, *Circuit Judge*

HON. HUBERT L. WILL, Sr., *District Judge* *

No. 88-1531

JOHN C. ZINNIEL AND GAYLE A. ZINNIEL,
DAVID N. MERRYFIELD AND JANE A. MERRYFIELD,
JAMES G. SAMUELS AND MARGARET SAMUELS,
Petitioners-Appellants,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

Appeal from the United States Tax Court
Nos. 31100-84, 31101-84, 31102-84
Thomas B. Wells, Judge

---

* The Honorable Hubert L. Will, Senior United States District Judge for the Northern District of Illinois, is sitting by designation.

ORDER

On consideration of the petition for rehearing and suggestion for rehearing en banc filed in the above-entitled cause by petitioners-appellants on September 20, 1989, no judge in active service has requested a vote thereon, and all of the judges on the original panel have voted to deny a rehearing. Accordingly,

IT IS ORDERED that the aforesaid petition for rehearing be, and the same is hereby, DENIED.

APPENDIX B

UNITED STATES TAX COURT
Washington, D.C. 20217

Docket Nos. 31100-84
. 31101-84
31102-84

JOHN C. ZINNIEL AND GAYLE A. ZINNIEL, *et al.*,[1]
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

MEMORANDUM SUR ORDER

These cases are presently before us on petitioners' Motion for Litigation Costs, which was submitted pursuant to section 7430 [2] and Rule 231. The facts of these cases are set forth in *Zinniel v. Commissioner*, 89 T.C. No. 32 (August 26, 1987).[3] Along with the stipulated facts and attached exhibits, those facts are incorporated herein by reference.

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[1] Cases of the following petitioners are consolidated herewith: David N. Merryfield and Jane A. Merryfield, docket No. 31101-84; and James G. Samuels and Margaret Samuels, docket No. 31102-84.

[2] Unless otherwise noted, all section and Code references are to the Internal Revenue Code, as amended and in effect during the years in issue. All Rule references are to the Tax Court Rules of Practice and Procedure.

[3] We have editorially corrected the reported opinion for the bound volume. The corrections were not substantive in nature.

Respondent's determinations in these cases were based upon his contention that an election made by Sierra Limited ("Sierra") under section 1372(a) to be taxed under subchapter S of the Code (this election is hereinafter referred to as a "subchapter S election") was not terminated by new shareholders in Sierra in the manner required by section 1372(e)(1) and the regulations thereunder. According to respondent, in order to terminate a corporation's subchapter S election, section 1372(e)(1) and the regulations thereunder regulated new shareholders to file a document with the Internal Revenue Service (hereinafter sometimes referred to as the "Service") within a 60-day statutory period, indicating that they refused to consent to the election. The parties stipulated that the new shareholders in Sierra filed a document entitled "Refusal to Consent to Small Business Corporation Election" with Sierra within the 60-day period, but did not file it with the Service. If Sierra's subchapter S election had not been terminated, petitioners, as shareholders in Sierra, would have been required to report additional taxable income on their tax returns for the taxable years in issue. We disagreed with respondent's argument that the new shareholders were required to file a document with the Service, and held in favor of petitioners. *Zinniel v. Commissioner, supra.*

Section 7430 provides that the prevailing party in a civil tax case may be awarded a judgment for reasonable litigation costs. The term "prevailing party" is defined in section 7430(c)(2) as a party that establishes that the position of the United States in the civil proceeding was unreasonable,[4] and has neither substantially

[4] The reasonableness standard of sec. 7430(c)(2) was amended by sec. 1551(d), Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2752, to allow an award of reasonable litigation costs when the Government's position is not "substantially justified." The amendment applies to actions commenced after December 31, 1985. The amendment is more in the nature of form than substance, and our

prevailed with respect to the amount in controversy or has substantially prevailed with respect to the most significant issue presented. Recovery of reasonable litigation costs by a prevailing party is subject to the limitations set forth under section 7430(b). One such limitation is that it must be determined by the relevant court that the prevailing party "has exhausted the administrative remedies available to such party within the Internal Revenue Service." Section 7430(b)(2).

Petitioners argue that they have satisfied the requirements and limitations of section 7430, and that they should be awarded reasonable litigation costs in the amount of $10,924.57. Respondent agrees that petitioners have substantially prevailed with respect to the amounts in controversy and the most significant issues in these cases, but objects to petitioners' motion for each of the following reasons:

(1) Respondent's position in these cases was reasonable;

(2) Petitioners did not exhaust their administrative remedies within the Service; and

(3) The amount of litigation costs sought by petitioners is unreasonable.[5]

We hold that petitioners have not proved that respondent's position in these cases was unreasonable. Petitioners therefore are not prevailing parties in this proceeding, and are not entitled to litigation costs.

Petitioners have the burden of proving that the position of the United States in the civil proceeding was unreasonable. Section 7430(c)(2)(A)(i); Rule 232(e).

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decision here would not change even if the amendment were applicable to these cases. See *Sher v. Commissioner*, 89 T.C. (July 9, 1987), slip op. at 9.

[5] This third ground only would limit petitioners' recovery of costs to the extent they were unreasonable.

Respondent's failure to succeed at litigation does not necessarily require a determination that his position was unreasonable. *Minahan v. Commissioner*, 88 T.C. 492, 498 (1987); *Wasie v. Commissioner*, 85 T.C. 962, 969 (1986). We have based determinations of the reasonableness of respondent's position upon respondent's position from the time a petition was filed (i.e., from the time litigation commenced). *Rutana v. Commissioner*, 88 T.C. —— (May 19, 1987); *Minahan v. Commissioner, supra* at 489-501; *Wasie v. Commissioner, supra* at 967.[6] However, we have reviewed "the events that occur[red] before a petition [was] filed to determine whether respondent acted reasonably in pursuing litigation in light of what he knew at the time the litigation was commenced." *Rutana v. Commissioner, supra.*

Petitioners argue that respondent's position in these cases (i.e., that new shareholders must file an affirma-

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[6] The Courts of Appeals for various circuits that have considered this issue are split as to whether a court also may consider the Commissioner's position prior to the time a petition was filed in order to determine whether the Commissioner's position was reasonable. Compare *Ewing and Thomas, P.A. v. Heye*, 803 F.2d 613, 615 (11th Cir. 1986); *Baker v. Commissioner*, 787 F.2d 637, 641-642 (D.C. Cir. 1986), affg. on this issue 83 T.C. 822, 827 (1984); *United States v. Balanced Financial Management, Inc.*, 769 F.2d 1440, 1450 (10th Cir. 1985) (holding statute only permits examination of the Commissioner's position from date petition is filed), with *Powell v. Commissioner*, 791 F.2d 385, 391-392 (5th Cir. 1986), revg. a Memorandum Opinion of this Court; *Kaufman v. Egger*, 758 F.2d 1, 3-4 (1st Cir. 1985) (holding statute also requires examination of the Commissioner's position at administrative level). The Seventh Circuit, to which the cases at bar are appealable, has not ruled on the issue. See *Golsen v. Commissioner*, 54 T.C. 742, 757-758 (1970), affd. 445 F.2d 985 (10th Cir. 1971).

Section 7430(c) was amended by sec. 1551(e), Tax Reform Act of 1986, Pub. L. 99-514, 100 Stat. 2752, to define specifically the term "position of the United States" to include any administrative action or inaction by *District Counsel*. The amendment only applies to actions commenced after December 31, 1985, and therefore is not applicable to the instant cases, which were commenced in 1984.

tive refusal to consent with the Service to terminate a subchapter S election) was unreasonable because it lacked any legal foundation.[7] We disagree.

The issue that was before us in the instant cases with respect to the requirements of section 1372(e)(1) had never been addressed by any court. Moreover, the instant cases involved a complex analysis of section 1372(e)(1) and that section's legislative history, as well as the regulations underlying section 1372(e)(1). While we disagreed with respondent's reading of those materials, we do not think that his position concerning section 1372(e)(1) was unreasonable "in light of what he knew at the time the litigation was commenced." *Rutana v. Commissioner, supra.*

Based upon the record as a whole, we hold that petitioners have not satisfied their burden of proving that respondent's position was unreasonable; thus, petitioners are not entitled to litigation costs under section 7430. Since our holdings on the question of the reasonableness of respondent's position prohibits petitioners' recovery of

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[7] Petitioners' motion only states that respondent's "position and actions" were unreasonable "in that the Respondent took the position that the new shareholders must file an affirmative refusal to consent * * * with the * * * Service in order to terminate the * * * Sub-Chapter S election." Petitioners then set forth 14 numbered paragraphs that petitioners represent to be the facts supporting the statement. Some of the paragraphs contain petitioners' legal conclusions and facts not in evidence, while other paragraphs contain facts that do not support petitioners' statement with respect to respondent's position. As we read petitioners' motion, the crux of petitioners' argument is that respondent's position was unreasonable because it was without any basis in law, and it is that argument that we specifically address in the text above.

Petitioners' Memorandum in Support of Litigation Costs, which was filed subsequent to petitioners' Motion for Litigation Costs, has been considered and does not raise any new or meritorious arguments with respect to this issue.

costs, we need not address respondent's other contentions. Based upon the foregoing, we deny petitioner's motion.

/s/ Thomas B. Wells
THOMAS B. WELLS
Judge

Dated: Washington, D.C.
December 8, 1987

UNITED STATES TAX COURT
Washington, D.C. 20217

Docket Nos. 31100-84
31101-84
31102-84

JOHN C. ZINNIEL AND GAYLE A. ZINNIEL, *et al.*,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ORDER

For the reasons set forth in the Memorandum Sur Order served herewith it is

ORDERED that petitioners' Motion for Litigation Costs, filed September 28, 1987, is denied.

/s/ Thomas B. Wells
THOMAS B. WELLS
Judge

Dated: Washington, D.C.
December 8, 1987

APPENDIX C

UNITED STATES TAX COURT
Washington, D.C. 20217

Docket Nos. 31100-84—31102-84

JOHN C. ZINNIEL AND GAYLE A. ZINNIEL, *et al.*,[1]
Petitioners,
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Filed August 26, 1987

Eugene O. Duffy, for the petitioners.

James M. Klein, for the respondent.

OPINION

WELLS, *Judge*:* By statutory notice of deficiency dated June 6, 1984, respondent determined deficiencies in petitioners' income taxes for the taxable years ended December 31, 1978, and December 31, 1979, as follows:

Docket No.	*Petitioner*	*Year*	*Deficiency*
31100-84	John C. Zinniel	1978	$6,552
	and Gayle A. Zinniel	1979	631
31101-84	David N. Merryfield	1978	7,551
	and Jane A. Merryfield	1979	632
31102-84	James G. Samuels	1978	5,857
	and Margaret Samuels	1979	406

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[1] Cases of the following petitioners are consolidated herewith: David N. Merryfield and Jane A. Merryfield, docket No. 31101-84; and James G. Samuels and Margaret Samuels, docket No. 31102-84.

* By order of the Chief Judge, this case was assigned to Judge Wells for decision and opinion.

The issue presented for our decision is whether a new shareholder in a "small business corporation" that has made an election under section 1372(a)[2] to be taxed under subchapter S of the Code is required to file an affirmative refusal to consent with the Internal Revenue Service in order to terminate the corporation's election.

This case was submitted fully stipulated. The stipulation of facts and exhibits attached thereto are incorporated herein by reference.

Petitioners John C. Zinniel and Gayle A. Zinniel are husband and wife, and resided in Dousman, Wisconsin, at the time their petition in this case was filed. They filed. They filed joint Federal income tax returns for the taxable years 1978 and 1979.

Petitioners David N. Merryfield and Jane A. Merryfield are husband and wife, and resided in Dousman, Wisconsin, at the time their petition in this case was filed. They have filed joint Federal income tax returns for the taxable years 1978 and 1979.

During the taxable years 1978 and 1979, petitioners James A. Samuels and Margaret Samuels were husband and wife. At the time their petition in this case was filed, Mr. Samuels resided in North Prairie, Wisconsin, and Ms. Samuels resided in Dousman, Wisconsin. The Samuels filed joint Federal income tax returns for the taxable years 1978 and 1979.

Sierra Limited (Sierra) was incorporated under the laws of Wisconsin on March 5, 1976. At that time, Messrs. Merryfield, Samuels, and Zinniel each owned one-third of the outstanding 900 shares of stock in Sierra (or 300 shares each). Sierra used a fiscal taxable year ending March 31. Sierra made an election under section

[2] Unless otherwise provided, all section and Code references are to the Internal Revenue Code of 1954 as amended and in effect during the years in issue.

1372(a) to be taxed under subchapter S of the Code (the election is hereinafter referred to as a subchapter S election), and the election was first effective for Sierra's fiscal taxable year ended on March 31, 1977.

It was decided that Sierra would adopt a qualified pension plan during 1977. Sierra's advisers were asked to "make the necessary changes." [3]

Petitioners' legal adviser, Patrick J. O'Neil (O'Neil), advised petitioners that a termination of Sierra's subchapter S election could be effected by a failure of new shareholders to consent to the election after becoming shareholders.[4]

On November 30, 1977, each Sierra shareholder (i.e., Messrs. Merryfield, Samuels, and Zinniel) transferred 30 shares of Sierra stock to his spouse. At that same time, a document entitled "Refusal to Consent to Small Business Corporation Election" (hereinafter referred to as the Refusal to Consent) was executed by the spouses (hereinafter referred to as the new Sierra shareholders) and filed with Sierra. The Refusal to Consent states as follows:

[3] The stipulation of facts in this case does not specify the changes that were requested.

[4] This advice was apparently given to petitioners in connection with the decision to adopt a qualified pension plan.

REFUSAL TO CONSENT TO
SMALL BUSINESS CORPORATION ELECTION

SIERRA LIMITED
2306 Grandview Blvd.
Waukesha Wisconsin 53186

WE, the undersigned shareholders hereby refuse to consent to the election of the above corporation, SIERRA LIMITED, to be treated as a small business corporation under Section 1372(a) of the Internal Revenue Code.

NAME	ADDRESS	NUMBER OF SHARES	DATE SHARES ACQUIRED
Jane Merryfield		30	11/30/77
Margaret Samuels		30	11/30/77
Gayle Zinniel		30	11/30/77

Dated: November 30, 1977 (S) Jane Merryfield
JANE MERRYFIELD

Dated: November 30, 1977 (S) Margaret Samuels
MARGARET SAMEULS [sic]

Dated: 11/30/77 (S) Gayle A. Zinniel
GAYLE ZINNIEL

On November 30, 1977 (the same date that the Refusal to Consent was filed with Sierra), a Form 5301, Application for Determination for Defined Contribution Plan, was filed with the Internal Revenue Service (hereinafter referred to as the Service). The form reflects that Sierra was a "Corporation" rather than a "Subchapter S Corporation." The Service issued a favorable determination letter with respect to the qualified status of Sierra's employee pension plan.

The following document was attached to the income tax return filed on behalf of Sierra for Sierra's taxable year ended March 31, 1978:

Dear Sirs:

In accordance with the requirements of Regulation Section 1.1372-4(b)(1)(iii), this is to notify you of the termination of the election to be subject to Sub-Chapter S made by Sierra Limited, Post Office 247, North Prairie, Wisconsin 53153. The election was terminated by the failure of new shareholders to consent to the election within the required time. On November 30, 1977, Jane Merrifield, Margaret Samuels and Gayle Zinniel each acquired thirty shares of Sierra Limited. They subsequently failed to consent to the election to treat Sierra Limited as a Sub-Chapter S corporation.

SIERRA LIMITED

By: ______________________

JOHN C. ZINNIEL, *Agent*

On December 28, 1978, pursuant to a request by one of respondent's employees, Sierra's accountant sent a letter to respondent, along with the Refusal to Consent. Respondent subsequently determined that Sierra's subchapter S election had not been effectively terminated, and that petitioners were therefore required to report on their tax returns for the taxable years in issue their distributive shares of Sierra's income, loss, and various credits, as well as certain excess contributions that had been made on behalf of petitioners under the Sierra pension plan.

The issue to be decided in this case requires an analysis of section 1372(e)(1) and the regulations thereunder.

Section 1372(e)(1)

Section 1372(a) provides that under certain circumstances, a small business corporation may elect not to be subject to normal income taxes and surtaxes.[5] This election is commonly referred to as a "subchapter S election."

Section 1372(e)(1) provides, in relevant part, as follows:

> (A) An election under subsection (a) made by a small business corporation shall terminate if any person who was not a shareholder in such corporation—
>
> > (i) on the first day of the first taxable year of the corporation for which the election is effective, if such election is made on or before such first day, or
> >
> > (ii) on the day on which the election is made, if such election is made after such first day,
>
> *becomes a shareholder in such corporation and affirmatively refuses (in such manner as the Secretary shall by regulations prescribe) to consent to such election* on or before the 60th day after the day on which he acquires the stock.
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> * * * *
>
> (C) Any termination of an election under subparagraph (A) by reason of the affirmative refusal of any person to consent to such election shall be effective for the taxable year of the corporation in

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[5] The effect of the election is that the corporation that makes the election and the corporation's shareholders are subject to the provisions of subch. S of the Code. Sec. 1372(b).

Sec. 1372 was redesignated as sec. 1362 by sec. 2, Subchapter S Revision Act of 1982, 96 Stat. 1669. Furthermore, the "normal tax" and "surtax" terminology was abolished by sec. 301(a), Revenue Act of 1978, 92 Stat. 2820, for taxable years beginning after Dec. 31, 1978.

which such person becomes a shareholder in the corporation and for all succeeding taxable years of the corporation.

[Emphasis supplied.[6]]

Respondent contends that the Refusal to Consent that was filed with Sierra by the new Sierra shareholders was not an effective "affirmative refusal" under section 1372(e)(1) because the Refusal to Consent was not filed with the Service. Petitioners contend that the plain meaning of the statutory language contained in section 1372(e)(1) did not require the new Sierra shareholders to file the Refusal to Consent with the Service in order to terminate Sierra's subchapter S election. Petitioners further contend that the legislative history of section 1372(e)(1) does not clearly indicate that Congress intended to require by statute that new shareholders file a document with the Service that manifests an affirmative refusal to consent in order to terminate a subchapter S election. We agree with petitioners.

The Supreme Court has set out the following canons of statutory construction, which are a fitting framework for the analysis of section 1372(e)(1):

> There is, of course, no more persuasive evidence of the purpose of a statute than the words by which the legislature undertook to give expression to its wishes. Often these words are sufficient in and of themselves to determine the purpose of the legisla-

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[6] Due to statutory modifications made under the Subchapter S Revision Act of 1982, "[A] person becoming a shareholder of a subchapter S corporation after the initial election will not have the power to terminate the election by affirmatively refusing to consent to the election (unless that person owns more than one-half of the voting stock)." S. Rept. 97-640 (1982), 1982-2 C.B. 718, 723. See also sec. 1362(d)(1), as amended by sec. 2, Subchapter S Revision Act of 1982, 96 Stat. 1669; H. Rept. 97-826 (1982); 1982-2 C.B. 730, 735. This provision is not applicable to the taxable years in issue in the instant case.

tion. In such cases we have followed their plain meaning. * * * Frequently, however, * * * when the plain meaning * * * [produced an unreasonable result] "plainly at variance with the policy of the legislation as a whole" this Court has followed that purpose, rather than the literal words. * * * [*United States v. American Trucking Associations*, 310 U.S. 534, 543 (1940). Fn. refs. omitted.]

Plain Meaning of the Statutory Language

Section 1372(e)(1) essentially provides that a subchapter S election that was made by a corporation shall terminate if any person becomes one of the corporation's shareholders within the period of time set for in the statute and affirmatively refuses to consent to the corporation's election "in such manner as the Secretary shall by regulations prescribe." The word "affirmative" is generally defined as an "assertion." Webster's Third International Dictionary (1981). The plain meaning of the statutory language "affirmatively refuse" therefore requires that a new shareholder in a subchapter S corporation assert a refusal to the continuation of the corporation's subchapter S election in order to revoke the election. Section 1372(e)(1) gives the Secretary [7] broad power to prescribe the manner in which new shareholders must assert their refusals, and does not set forth specific procedural requirements (other than the 60-day time requirement). Congress, in adopting the words contained in section 1372(e)(1), did not preclude the Secretary

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[7] References to the "Secretary" are to the Secretary of the Treasury or his delegate. Sec. 7701(a)(11)(B).

Sec. 301.7805-1, Proced. & Admin. Regs., provides, in relevant part, that the "Commissioner, with the approval of the Secretary, shall prescribe all needful rules and regulations for the enforcement of the Code * * *, including rules and regulations as may be necessary by reason of any alteration of law in relation to internal revenue."

from prescribing a method other than one which requires new shareholders to file an affirmative refusal to consent with the Service.[8] Therefore, we hold that the plain meaning of the relevant language under section 1372(e)(1) does not require a new shareholder to file an affirmative refusal to consent with the Service.

Purpose of the Legislation

When, in the past, we have had to determine whether the purpose for legislation was plainly at odds with the meaning of the relevant statutory language, we have required "*unequivocal evidence* of legislative purpose before construing the statute so as to override the plain meaning of the words used therein." *Huntsberry v. Commissioner*, 83 T.C. 742, 747-748 (1984) (emphasis supplied). See also *Estate of Sachs v. Commissioner*, 88 T.C. 769, 773 (1987). In the present case, the relevant inquiry is whether there is unequivocal evidence that Congress intended that section 1372(e)(1) would, by that section's own terms, and without any regulatory requirement, require the filing of an affirmative refusal to consent with the Service.

We start our inquiry by examining section 1372(e)(1), prior to its amendment by section 902(c)(3), Tax Reform Act of 1976, 90 Stat. 1609. For taxable years be-

[8] In instances where the Secretary is given the authority in the Code to prescribe the method for making a specified election, the method chosen to give effect to the election has not always been to require a filing with the Service. For example, sec. 48(d) allows a lessor of certain property to "elect," in effect, to pass through the investment tax credit to the lessee. Sec. 48(d) provides that the election is to be made "at such time, in such manner, and subject to such conditions as are provided by regulations prescribed by the Secretary." Regulations were issued pursuant to that section which allow property by property elections to be made by a lessor by filing a statement *with the lessee*. Sec. 1.48-4(f)(1), Income Tax Regs.

ginning before January 1, 1977, section 1372(e)(1)[9] required new shareholders in a corporation to consent to a corporation's subchapter S election under section 1372(a) within the period of time prescribed by the Secretary in order to avoid a termination of the corporation's election. Sec. 1.1372-3(b), Income Tax Regs.,[10] re-

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[9] Sec. 1372(e)(1) provided as follows for taxable years beginning before Jan. 1, 1977:

> (1) NEW SHAREHOLDERS.—An election under subsection (1) made by a small business corporation shall terminate if any person who was not a shareholder in such corporation—
>
> (A) on the first day of the first taxable year of the corporation for which the election if effective, if such election is made on or before such first day, or
>
> (B) on the day on which the election is made, if such election is made after such first day,
>
> becomes a shareholder in such corporation and does not consent to such election within such time as the Secretary shall prescribe by regulations. Such termination shall be effective for the taxable year of the corporation in which such person becomes a shareholder in the corporation and for all succeeding taxable years of the corporation.

[10] The relevant portion of sec. 1.1372.3(b), Income Tax Regs., provided as follows:

> (b) *New shareholders.* If a person becomes a shareholder of an electing small business corporation after the first day of the taxable year for which the election is effective, or after the day on which the election is made (if such day is later than the first day of the taxable year), the consent of such shareholder shall be made in a statement filed (with the internal revenue officer with whom the election is filed) within the period of 30 days beginning with the day on which such person becomes a new shareholder. A copy of such consent should be furnished to the corporation by the new shareholder. If the new shareholder is an estate, the 30 day period shall not begin until the executor or administrator has qualified under local law to perform his duties, but in no event shall such period begin later than 30 days following the close of the corporation's taxable year in which the estate became a shareholder. The statement of consent shall set forth the name and address of the corporation and of such new shareholder, the number of

quired that the consent "be made in a statement filed (with the internal revenue officer with whom the election is filed) within the period of 30 days beginning with the day on which such person becomes a new shareholder." The Commissioner granted extensions of time for filing consents if "there was reasonable cause for the failure to file" the consents, and certain other conditions were satisfied. Sec. 1.1372-3(c), Income Tax Regs.[11]

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shares of stock owned by such shareholder, the date on which such shares were acquired, and the name and address of each person from whom such shares were acquired. A copy of the consent of such new shareholder shall be filed with the return required to be filed under section 6037 for the taxable year to which such consent applies. * * *

[11] Sec. 1.1372-3(c), Income Tax Regs., provided as follows:

(c) *Extension of time for filing consents.* An election which is timely filed for any taxable year and which would be valid, or would not have terminated, except for the failure of any shareholder to file a consent within the time prescribed in paragraph (a) or (b) of this section will not be invalid, or will not be treated as having terminated, for such reason if—

(1) It is shown to the satisfaction of the district director or director of the service center that there was reasonable cause for the failure to file such consent and that the interests of the Government will not be jeopardized by treating such election as valid, or as not having terminated,

(2) Such shareholder files a proper consent to the election within such extended period of time as may be granted by the Internal Revenue Service, and

(3) New consents are filed within such extended period of time as may be granted by the Internal Revenue Service, by all persons who were shareholders of the corporation at any time during the taxable year with respect to which the failure to consent would (but for the provisions of this paragraph) cause the corporation's election to be invalid or to terminate, and by all persons who were shareholders of the corporation subsequent to such taxable year and prior to the date on which an extension of time is granted in accordance with this paragraph.

As part of the Tax Reform Act of 1976, Congress changed the statutory consent requirement to a statutory affirmative refusal to consent requirement and changed the 30-day regulatory period for filing the consent with the Service to a 60-day statutory period for making an affirmative refusal. Sec. 902(c)(3), Tax Reform Act of 1976, 90 Stat. 1609.

The origin for the adoption of the changes by the Conference Committee was a Senate floor amendment. See S. Rept. 94-1236 (Conf.) (1976), 1976-3 C.B. (Vol. 3) 807, 953 (Senate amendment numbered 62); UP Amendment 338, 122 Cong. Rec. 26148 (1976). There are no committee reports with respect to the Tax Reform Act of 1976 that provide guidance concerning the issue whether Congress intended that section 1372(e)(1) would require new shareholders in a corporation that had made a subchapter S election to file an affirmative refusal to consent with the Service in order to terminate the election.

The relevant portion of the General Explanation of the Tax Reform Act of 1976 (hereinafter referred to as the General Explanation, but also commonly referred to as the Blue Book) provides as follows:

> *Prior law*
>
> Statutory rules provide generally that all shareholders of a corporation must consent to either an election of subchapter S status or to a voluntary revocation of this election. However, prior law provided that an election of subchapter S status would be involuntarily terminated if any new shareholder of the corporation did not affirmatively consent to the election, generally within a period of 30 days from the day he became a new shareholder. *A consent for this purpose involved a formal filing with the Internal Revenue Service.*

Reason for change

The requirement of a new shareholder's affirmative consent to a subchapter S election within a limited period of time could result in an inadvertent termination of the election if the new shareholder failed to file a timely consent or was not aware of the necessity of filing a consent. Congress was concerned that a termination of subchapter S status in these circumstances would cause a severe hardship not only to the new shareholder but to all shareholders of the corporation. It therefore decided to require that a new shareholder must affirmatively refuse to consent to a subchapter S election in order to terminate such an election.

Explanation of provision

Under the Act, in order for a subchapter S election to be terminated, a new shareholder must affirmatively refuse to consent to the election within 60 days from the time he acquired his stock in the corporation. In the case where a decedent's estate is the new shareholder, the 60 day period for *filing* an affirmative refusal will begin upon the earlier of either the day on which the executor or administrator of the estate qualifies or the last day of the corporation's taxable year during which the decedent's death occurred. The Secretary is authorized to issue regulations prescribing the manner in which an affirmative refusal is to be *filed.*

[Staff of the Joint Comm. on Taxation, General Explanation of the Tax Reform Act of 1976, 1976-3 C.B. (Vol. 2) 1, 223. Emphasis supplied.]

While the General Explanation contains several references to "filing," those references are not unequivocal evidence of legislative intent to require by *statute* that new shareholders file affirmative refusals to consent with

the Service. The General Explanation was prepared by the *staff* of the Joint Committee, and was issued *after* section 1372(e)(1) was drafted. The General Explanation therefore "does not directly represent the views of the legislators or an explanation available to them when acting on the bill" (*McDonald v. Commissioner*, 764 F.2d 322, 336-337 n.25 (5th Cir. 1985), affg. a Memorandum Opinion of this Court), and is technically not part of the legislative history of the Tax Reform Act of 1976 (*Estate of Hutchinson v. Commissioner*, 765 F.2d 665, 669-670 (7th Cir. 1985), affg. a Memorandum Opinion of this Court; *Estate of Sachs v. Commissioner*, 88 T.C. at 775 n.3). For these reasons, the portion of the General Explanation noted above, standing alone, without any direct evidence of legislative intent, is not unequivocal evidence of legislative intent to require that new shareholders in a corporation that has made a subchapter S election file an affirmative refusal to consent with the Service in order to terminate the corporation's election.[12]

Based upon the sparse legislative history underlying section 1372(e)(1) and the General Explanation, we are

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[12] While the General Explanation would not, alone, provide this Court with the unequivocal evidence required by this Court for purposes of performing the analysis announced in *United States v. American Trucking Associations*, 310 U.S. 534, 543 (1940), we recognize that the General Explanation has been relied upon by the Supreme Court in its analysis of tax statutes (see, e.g., *FPC v. Memphis Light, Gas & Water Div.*, 411 U.S. 458, 471-472 (1973)), as well as by this Court (see, e.g., *Estate of Sachs v. Commissioner*, 88 T.C. 769 (1987)), and is entitled to great respect (*McDonald v. Commissioner*, 764 F.2d 322, 336-337 n.25 (5th Cir. 1985), affg. a Memorandum Opinion of this Court).

Even if we assume that the General Explanation could provide us with the necessary evidence of legislative intent for purposes of our analysis in this case, use of various forms of the term "file" by the staff of the Joint Committee on Taxation in its explanation of the affirmative refusal requirement may only indicate that Congress expected that the Secretary would issue regulations requiring new shareholders to file affirmative refusals with the Service.

not prepared to find that Congress was attempting to require by *statute* that new shareholders file affirmative refusals to consent with the Service, and thereby preclude the Secretary from prescribing some other manner for new shareholders to affirmatively refuse to consent under section 1372(e)(1). We therefore hold that the plain meaning of the statutory language contained in section 1372(e)(1) is not "plainly at variance with the policy of the legislation as a whole." Thus, we follow the statute's literal words, which do not require that an affirmative refusal to consent be filed with the Service in order to terminate a subchapter S election.

Proposed Regulations

As noted in our analysis of section 1372(e)(1), that section states that a corporation's subchapter S election terminates when a new shareholder "affirmatively refuses (*in such manner as the Secretary shall prescribe*) to consent to such election." (Emphasis supplied.) No regulations had been issued under section 1372(e)(1) prior to the time petitioners attempted to revoke Sierra's subchapter S election.[13] Finally, on April 17, 1980, after the taxable years in issue, proposed regulations under section 1372(e)(1) were published.[14] See 45 Fed. Reg.

[13] Regulations "must, by their terms and in their application, be in harmony with [statutory law]." *Scofield v. Lewis*, 251 F.2d 128, 132 (5th Cir. 1958). In the instant case, sec. 1.1372-3(b), Income Tax Regs., still only interprets sec. 1372(e)(1) prior to its amendment by sec. 902(c)(3) of the Tax Reform Act of 1976; thus, that regulatory section only deals with the requirement under prior law that a new shareholder consent to a corporation's subch. S election within the period of 30 days beginning with the day on which the person becomes a new shareholder, and is not by its terms and in its application in harmony with sec. 1372(e)(1), as amended by sec. 902(c)(3), Tax Reform Act of 1976, 90 Stat. 1609. The filing requirement under sec. 1.1372-3(b), Income Tax Regs., therefore, does not apply to sec. 1372(e)(1), as amended.

[14] No temporary or final regulations were ever issued under sec. 1372(e)(1), as amended by sec. 902(c)(3), Tax Reform Act of 1976, 90 Stat. 1609.

26092, 26097 (Apr. 17, 1980); secs. 1.1372-3(b)(1), 1.1372-3(b)(2), 1.1372-3(b)(3), Proposed Income Tax Regs. These proposed regulatory sections provide, in relevant part, as follows:

> (b) *New shareholders*—(1) *General rule.* (i) If a person becomes a shareholder of an electing small business corporation after the day on which the [corporation's subchapter S] election is made, the new shareholder must affirmatively refuse to consent to the election in order to terminate the election. The affirmative refusal to consent must be made in a statement filed (with the service center with which the election is filed) within the period of 60 days beginning with the day after the day on which the person becomes a new shareholder. A copy of the refusal to consent should be furnished to the corporation by the new shareholder. * * * The statement of affirmative refusal to consent must set forth the name and address of the corporation and of the new shareholder, the taxpayer identification number of the corporation, the number of shares of stock owned by the new shareholder, the date on which the shares were acquired, and the name and address of each person from whom the shares were acquired. A copy of the affirmative refusal to consent of the new shareholder must be filed with the return required to be filed by the electing small business corporation under section 6037 for the taxable year to which the affirmative refusal to consent applies.
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> * * * *
>
> (2) *Years beginning after 1976 and before 1979.* For taxable years beginning after 1976 and before 1979, if a person becomes a shareholder of an electing small business corporation after the first day of the first taxable year for which the election is effective, or after the day on which the election is made (if that day is later than the first day of the taxable

year), the new shareholder must affirmatively refuse to consent to the election in order to terminate the election. The affirmative refusal to consent is made in the same manner as for taxable years beginning after 1978 under paragraph (b)(1)(i) of this section.

(3) *Prior defective affirmative refusals to consent.* A timely defective affirmative refusal to consent filed by a shareholder with the Internal Revenue Serve prior to [the date which is 30 days after the day on which these regulations are published in the Federal Register as a Treasury decision] will be considered effective by the Internal Revenue Service if the names of both the shareholder and the corporation are set forth in the statement of affirmative refusal to consent. For this purpose, a defective affirmative refusal to consent is one that was not properly filed or did not contain all the information required by paragraph (b)(1)(i) or (2) (as the case may be) of this section.

Both respondent and petitioners have made numerous arguments concerning the applicability of these proposed regulations to this case.[15] Nevertheless, proposed regulations are merely suggestions made for comment. See *LeCroy Research Systems Corp. v. Commissioner*, 751 F.2d 123, 127 (2d Cir. 1984), revg. on other grounds a Memorandum Opinion of this Court; *F.W. Woolworth v. Commissioner*, 54 T.C. 1233, 1265-1266 (1970). Proposed regulations "carry no more weight than a position advanced on brief by the respondent." *F.W. Woolworth*

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[15] Respondent argues that secs. 1.1372-3(b)(1) and 1.1372-3(b)(2), Proposed Income Tax Regs., 45 Fed. Reg. 26097 (Apr. 17, 1980), apply to the present case and required the new Sierra shareholders to file the Refusal to Consent with the Service. Petitioners argue that even if the proposed regulations have legal effect, sec. 1.1372-3(b)(3), Proposed Income Tax Regs., cured any defect with respect to the Refusal to Consent.

v. Commissioner, supra. If respondent wanted these sections of the regulations to carry more weight than a position advanced on brief, he could have issued them as temporary regulations. *LeCroy Research Systems Corp. v. Commissioner, supra.* Thus, we hold that the proposed regulations cited by the parties do not have the force of law, and therefore are not determinative of the issue whether an affirmative refusal to consent under section 1372(e)(1) must be filed with the Service.

This Court recognizes that the process for issuing Treasury regulations is often slow, due to the many levels of review and the procedures for notice and comment to which regulations are usually subject.[16] Nevertheless, we fail to understand how the Secretary could fail to issue any temporary or final regulations prescribing the procedures for new shareholders to affirmatively refuse to consent to subchapter S elections when there was a statutory direction to issue such regulations (the statute required that new shareholders affirmatively refuse to consent "in such manner as the Secretary *shall* by regulations prescribe").[17] (Emphasis supplied.) Furthermore, in light of the prior regulatory requirement under section 1.1372-3, Income Tax Regs., that new shareholders file consents to the continuation of subchapter S elections with the Service, it does not appear that it would have been diffi-

[16] See Administrative Procedure Act of 1946, 5 U.S.C. secs. 553(b), 553(c), 553(e) (1982) (specifying circumstances under which notice and comment procedures must be followed). See also 4 B. Bittker, Federal Taxation of Income, Estates, and Gifts, par. 110.4.1, at 110-25—110-27 (1981) (discussing Treasury regulations, generally, including notice and comment procedures).

[17] Sec. 343(b)(2), Revenue Act of 1978, 92 Stat. 2844, and sec. 5(b)(1), Act of Nov. 10, 1978, Pub. L. 95-628, 92 Stat. 3628, changed the relevant regulatory language to "in such manner as the Secretary *may* by regulations prescribe." (Emphasis supplied.) The effect of that change can be of no concern to this Court since the change does not apply to the taxable years in issue. See *First Chicago Corp. v. Commissioner*, 88 T.C. 663, 676 n.11 (1987).

cult to issue temporary regulations prescribing similar filing requirements for new shareholders to affirmatively refuse to consent. Finally, if the Commissioner and the Secretary deemed a filing requirement to be crucial to their ability to administer section 1372(e)(1), they should have issued temporary or final regulations prescribing the requirement. It is obvious that the amendment of section 1372(e)(1) was an attempt by Congress to remove a trap for the unwary, i.e., an inadvertent termination of a subchapter S election. The failure to issue temporary or final regulations under the new statutory section frustrated that purpose by creating a new trap, i.e., an inadvertent failure to terminate a subchapter S election.

The parties have stipulated that the Refusal to Consent in the instant case was filed with Sierra by the new Sierra shareholders within the 60-day statutory period for filing an affirmative refusal to consent. Pursuant to the foregoing statutory and regulatory analyses, we hold that the filing of the Refusal to Consent with Sierra by the new Sierra shareholders constituted an affirmative refusal to consent for purposes of section 1372(e)(1), and that Sierra's subchapter S election was terminated for the taxable years in issue.

Petitioners made several additional arguments in the instant case. Our analysis in this case, however, makes it unnecessary for us to consider those arguments.

To reflect the foregoing,

Decisions will be entered for the petitioners.